Information Request AG-1-19

Please provide the workpapers, calculations, formulas, assumptions, supporting documentation and copies of any studies management relied on to choose the Post-Retirement Benefits Other Than Pension study's assumed return on trust fund assets.

Response

Please see the Company's response to Information Request AG-1-9.

Information Request AG-1-20

Please provide the workpapers, calculations, formulas, assumptions, supporting documentation and copies of any studies management relied on to choose the Post-Retirement Benefits Other Than Pension study's trends in health care, Medicare and prescription drug costs.

Response

Please refer to the Company's response to Information Request AG-1-21(d), as provided in response to discovery in the Compliance Filing phase of D.T.E. 03-47.

Information Request AG-1-27

Please provide a copy of the companies' response to the Attorney General's inquiry in December 2003 concerning the compliance filing.

Response

Please refer to Attachment AG-1-27.

KEEGAN, WERLIN & PABIAN, LLP

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265 FRANKLIN STREET
BOSTON, MASSACHUSETTS 02110-3113

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December 22, 2003

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station
Boston, MA 02110

Re: D.T.E. 03-47-A, Boston Edison Company, Cambridge Electric Light Company, Commonwealth Electric Company, NSTAR Gas Company, Pension/PBOP Adjustment Factor Compliance Filing

Dear Secretary Cottrell:

By this letter, Boston Edison Company, Cambridge Electric Light Company, Commonwealth Electric Company and NSTAR Gas Company (together, the "Company") respond to the Attorney General's letter dated December 10, 2003, requesting that the Department of Telecommunications and Energy (the "Department") allow discovery,[1] hearings and briefs on the Company's calculation of the Pension Adjustment Factor (the "PAF").[2] The Attorney General claims that a full "examination" is necessary because (1) the Company's PAF schedules contain "new, subjective and undocumented information;" and (2) the schedules were not presented during the hearings in this case (Attorney General Letter at 1). As described below, the Company's PAF Filing is based directly on the sample calculation presented in DTE-1-4(Rev) in D.T.E. 03-47-A and incorporates the exact amounts and calculations presented in that exhibit except where necessary to institute changes expressly required by the Department's Order.

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1 The Company has already responded to 27 information requests issued by the Attorney General and one issued by the Department in relation to this compliance filing.

2 On December 1, 2003, the Company filed with the Department: (1) compliance tariffs to establish a Pension/PBOP Adjustment Mechanism for each NSTAR retail company pursuant to the Department's directives in Boston Edison Company, Commonwealth Electric Company, Cambridge Electric Light Company and NSTAR Gas Company, D.T.E. 03-47-A (2003) (the "Order"); and (2) the Company's first annual Pension/PBOP Adjustment Factors for effect January 1, 2004 (the "PAF Filing"). Although motions for clarification and reconsideration of the Order are now pending before the Department, the issues raised in the motions do not require resolution by the Department prior to its approval of the compliance tariffs and PAF Filing. The compliance tariffs and PAF Filing serve only to implement the terms of the Department's Order and present no new information or calculations for the Department's consideration.

In that regard, the Attorney General claims that the Department should investigate at least five topics, including: (1) the balance of prepaid pension and PBOP amounts; (2) the actual amount of pension and PBOP expense included in the PAF calculation; (3) the level of pension and PBOP expense amounts currently included in rates; (4) the amount of pension and PBOP regulatory asset balances that have been deferred as a result of the Department's decisions in Boston Edison Company, D.P.U. 92-92 (1992) and Cambridge Electric Light Company, D.P.U. 92-250 (1993); and (5) the level of carrying charges allowed by the Department's Order (Attorney General Letter at 2-4). However, the record in D.T.E. 03-47 is clear on all of these points and the Attorney General's request for hearings represents an attempt to re-litigate issues already determined by the Department. Accordingly, the Department should deny the Attorney General's Motion.

(1) Prepaid Pension and PBOP Balances

The Attorney General claims that there are three reasons that the Department should investigate the prepaid amounts, which are: (1) there is no disaggregation of these balances to remove the prepaid amounts for non-retail businesses including generation, transmission and the holding company; (2) the prepaid amount balances are derived from the pension and PBOP actuarial studies requiring review of the underlying assumptions; and (3) a factor of 0.82 and 0.83 is applied, "without explanation" to determine the amount of deferred income taxes deducted from the prepaid balances (Attorney General Letter at 2). None of these claims has merit.

First, in terms of disaggregating the prepaid amounts among regulated and non-regulated companies, the record in D.T.E. 03-47 established that the prepaid pension and PBOP amounts included in the sample calculation presented in DTE-1-4(Rev), and duplicated in the PAF Filing, are the portion of the prepaid balances that relate exclusively to the four regulated retail companies.[3] Thus, it is not necessary or appropriate to "disaggregate" the balances included in the PAF Filing among the non-retail generation, transmission and holding company businesses.

Second, the Department's Order recognizes that prepaid amounts are the difference between amounts booked by the Company pursuant to SFAS 87 and SFAS 106 and cash amounts contributed by the Company to its pension and PBOP trust funds. Order at 33-34. Pension and PBOP prepaid balances are presented in the PAF Filing only for the purpose of calculating the carrying costs, which apply to the average annual

[3] The Company provided a comprehensive discussion of the derivation of the prepaid pension and PBOP amounts for 2002 and 2003 in the PAF Filing in response to the Attorney General's Information Requests AG-1-4, AG-1-5, AG-1-10 and AG-1-11, which were issued in relation to the compliance filing. In the 2004 PAF Filing, the Company will allocate the prepaid amounts based on actual, total-year 2003 labor benefits expenses. Please refer to the Company's response to Information Request AG-1-4.

balance of prepaid pension and PBOP expense. In D.T.E. 03-47, the Company calculated the average annual balance of pension and PBOP prepaid amounts by averaging the balances as of December 31, 2002 and December 31, 2003.[4] See, Exhibit DTE-1-4 (Rev), at Line 12. The amounts used in the PAF Filing (at lines 9 and 14) to calculate the prepaid pension and PBOP balances are the same as the amounts shown in Exhibit DTE-1-4 (Rev)(Line 12).

Moreover, there is no need to investigate the actuarial assumptions underlying the calculation of the projected 2003 SFAS 87 and SFAS 106 expense, which forms the basis of the prepaid balance calculation. The total prepaid pension and PBOP balances as of December 31, 2002 are computed as the difference between cash contributions to the fund in previous years and the Company's booked SFAS 87 and SFAS 106 expense. The actual 2003 prepaid balances will be known at the time the Company files its next PAF Filing in December 2004, and therefore, the Company expects that it will true-up to the actual 2003 prepaid balance by entity in that filing. As a result, it is not necessary or appropriate to expend resources at this time to "investigate" the assumptions underlying the actuarial studies that form the basis of the estimated 2003 SFAS 87 and SFAS 106 expense.

Third, the factors applied to determine the amount of deferred income taxes deducted from the prepaid balances were established in D.T.E. 03-47. See, e.g., Exhibit DTE-2-19 in D.T.E. 03-47. The Company provided a comprehensive response to the Attorney General's Information Request AG-1-6 on the PAF Filing, which referenced the record in D.T.E. 03-47 and explained that these factors reflect the capitalization rate applicable under Section 263A of the Internal Revenue Code.

Lastly, it should be noted that the Attorney General was provided with the full and fair opportunity to challenge or rebut the accuracy of these prepaid balance amounts in D.T.E. 03-47 and the Attorney General failed to do so. Granting additional hearings in this proceeding at this point in time would not produce any new information, nor would it be appropriate given that these amounts were presented and considered by the Department in D.T.E. 03-47.

(2) Pension/PBOP Expense Levels

The Attorney General claims that the Company's pension and PBOP expenses for 2003 must be "tested for appropriateness" regarding: (1) the actuarial assumptions underlying the projected expense; (2) the amount of costs allocated to regulated and non-regulated businesses; and (3) the capitalization rate. As with the Attorney General's other claims, it is not necessary or appropriate for the Department to investigate these issues in the context of this filing.

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4 As discussed below, the prepaid balances will be subject to reconciliation in the 2004 PAF Filing.

First, in terms of the actuarial assumptions underlying the 2003 expense, the Attorney General ignores the fact that (1) under the reconciliation mechanism, the Company recovers no more and no less than its booked SFAS 87 and SFAS 106 expense; and (2) the year-to-year calculation of SFAS 87 and SFAS 106 expense inherently accounts for the differences between the actuarial assumptions and actual experience in a given year, i.e., the expense derived under SFAS 87 and SFAS 106 in any given year is, in part, dictated by the reconciliation of actual experience in the current year to the actuarial assumptions made in the past year. The actuarial assumptions underlying the pension/PBOP expense calculation were presented in D.T.E. 03-47 (see, DTE-2-7 and AG-1-9). As a result, there is no need to investigate the actuarial assumptions underlying the calculation of the projected 2003 SFAS 87 and SFAS 106 expense.

Second, the calculations in the PAF Filing are based on the same allocation percentages and capitalization rates set forth in D.T.E. 03-47, at Exhibit DTE-1-4 (Rev). Specific references to the record in D.T.E. 03-47 are provided in response to Information Request AG-1-15, AG-1-18, AG-1-19 and AG-1-20 issued by the Attorney General on the PAF Filing. As stated therein, the capitalization rates are based on the historical proportion of company labor dedicated to capital work. The Company expects to true-up the 2003 allocation percentages and capitalization rates based on final actual results that will become available in 2004. As a result, further proceedings would not produce any new information, nor would it be appropriate to expend resources at this time to "investigate" the allocation percentages or capitalization rates.

The Attorney General was provided with the full and fair opportunity to challenge or rebut the accuracy of the SFAS 87 and SFAS 106 expense amounts in D.T.E. 03-47 and the Attorney General failed to do so. Granting additional hearings in this proceeding at this point in time would not produce any new information, nor would it be appropriate given that these amounts were presented and fully considered by the Department in D.T.E. 03-47.

(3) Pension/PBOP Amounts in Rates

The Attorney General claims that the Department should investigate and determine the amount of pension and PBOP expense included in rates. As explained by the Company in responses to the Attorney General's information requests on the PAF Filing, the level of Company pension and PBOP expense amounts currently included in rates was established on the record in D.T.E. 03-47-A.[5] The Company used the same amounts in the PAM-1 tariff and the PAF Filing at page 1, line 3 (divided by one-third to reflect the four-month period September through December 2003). The evidentiary

[5] See responses to Information Requests AG-1-1, AG-1-4, AG-1-5, AG-1-9, AG-1-10 and AG-1-11 filed on December 17, 2003, in answer to the Attorney General's compliance discovery.

record on the amount of pension/PBOP costs in rates is clear and uncontested, and therefore, it would be inappropriate for the Department to reopen evidentiary hearings to reconsider the record evidence in the compliance phase of this proceeding.[6]

(4) Deferral Balances

The Attorney General claims that new additional evidentiary hearings are needed to examine the amount of pension and PBOP regulatory assets balances that have been deferred as a result of the Department's decisions in: (1) Boston Edison Company, D.P.U. 92-92 (1992); and (2) Cambridge Electric Light Company, D.P.U. 92-250 (1993) (Attorney General Letter at 3-4). This request should be denied by the Department because the record in this case includes a full discussion and identification of these deferral balance amounts, both of which were not challenged or rebutted by the Attorney General during the hearings. In addition, the Department's Order explicitly approves the recovery of these deferral balances. Order at 45. To allow further examination of this information in the compliance phase of this proceeding is tantamount to the Department granting a motion for reconsideration where the record is clear and no error has been shown.[7]

(5) Carrying Charges

The Attorney General claims that when the Department allowed a return on the prepaid balances, it did not recognize or make any provision for grossing up that amount for income taxes (Attorney General Letter at 4). According to the Attorney General, the carrying charge rate should therefore be based on 8.16 percent, and not the 10.88 percent carrying charge used by the Company, which has been grossed up for income taxes. The Attorney General's argument seeks to create confusion where none is present, and should be rejected by the Department.

Both the record in the case and the Department's Order are clear that the return allowed by the Department will be grossed-up for income taxes. Indeed, the Department consistently has adopted a gross-up mechanism to incorporate the effect of income taxes

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6 This issue is also the subject of the Attorney General's separate Motion for Clarification, or the in the Alternative, for Reconsideration, dated November 20, 2003. As stated in the Company's response to the Attorney General's November 20 Motion, the amount of pension/PBOP expense in rates was determined in D.T.E. 03-47.

7 As stated in the Company's response to Information Requests AG-1-24 and AG-1-25 of the PAF Filing, Exhibit AG-1-44 in D.T.E. 03-47 presented the workpapers that detail the calculation of the 2003 beginning balance of the Boston Edison deferred pension costs relating to D.P.U. 92-92 and Cambridge Electric Light Company's deferred PBOP balances relating to D.P.U. 92-250. In addition, the prefiled testimony of Mr. Judge described the inclusion of these deferred balances in the Company's Pension Adjustment Mechanism, and specifically identified the unamortized balances associated with these deferrals. Exhibit NSTAR-JJJ at 32-33. This information was again included in Exhibit DTE-1-4 (Rev) at 2 (notes 1 and 2).

when calculating the allowed rate of return. See e.g., Western Massachusetts Electric Company, D.P.U. 86-280-A at 40 (1997) ("[The Department] ha[s] adjusted the net-of-tax rates of return used to compute the return, carrying charges and amortization, to reflect our findings as to the appropriate tax rates and cost of capital for the various periods over which the return, carrying charges and amortization are computed, as determined in this Order"). Mr. Judge testified that "the return will be based on the *tax-effected* weighted average cost of capital for each distribution company, as most recently applied by the Department." Exhibit NSTAR-JJJ at 33 (emphasis added). In addition, the Department's Order states that the "final component of the Companies' proposal is the recovery of carrying charges (or money costs), *based on the tax-effected* weighted cost of capital of each of the Companies . . ." Order at 33. Accordingly, no additional hearings are appropriate or necessary to examine the Department's allowed carrying costs in this case.

(6) Conclusion

The annual PAF factors will become effective on January 1 of each year based on financial data from the prior calendar year. By definition this means that the annual filing will precede the availability of complete and final financial data. The annual filings will involve amounts that are based, in part, on amounts established in D.T.E. 03-47 that do not change from year to year, and in part, on forecasted amounts that will need to be subsequently reconciled. As a result, there is no need to litigate every element of a reconciling formula, such as the transition charge, cost of gas adjustment charge and other reconciling mechanisms, before the factor is placed in rates. In general the Department routinely approves such rates, without full hearings, subject to a later true-up to actual amounts as the estimated amounts become finalized. In this specific matter, the Company's PAF Filing is entirely consistent with the numbers, methodologies and schedules presented in D.T.E. 03-47. The Attorney General has not raised any issues absent from the initial case and seeks only to relitigate issues already determined by the Department.

Accordingly, the Company requests that the Department approve the compliance filing and PAF for effect on January 1, 2004.[8]

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8 It is imperative that the PAF go into effect on January 1, 2004, coincident with new transition, standard offer, transmission and default service adjustment rates for Boston Edison, Cambridge and Commonwealth. The Company designed these rates (which must meet the statutory 15 percent, inflation adjusted rate reduction for standard offer service customers) based on the implementation of the PAF on January 1, 2004. Any delay in the implementation of the PAF would require changes in the other rates that are to go into effect on that date. See filings in D.T.E. 03-117 and D.T.E. 03-118.

Thank you for your attention to this matter.

Sincerely,

Robert J. Keegan / [illegible]

Robert J. Keegan

Enclosures

cc: Service List

Information Request AG-1-31

Please provide copies of all documents and correspondence, including e-mails, for the last 18 months between the Companies and its independent auditors regarding its pension and PBOPs.

Response

Please refer to Attachment AG-1-31 **(BULK)** for the requested information. A single copy of this BULK response is being provided to the Department and the Attorney General.

Farrell, Michael

From: teresa.m.medeiros@us.pwc.com

Sent: Tuesday, January 06, 2004 10:20 AM

To: Michael_Farrell@nstaronline.com; sheryl.a.sciaudone@us.pwc.com

Cc: francis.schlosser@us.pwc.com; james.c.horvath@us.pwc.com; lisa.g.ullman@us.pwc.com

Subject: Re: 12/31/03 Discount Rates

Mike,
The 12/31/2003 discount rates are now available, and are below (compared to the rates we gave you in September and October 2003).

	9/30/2003	10/31/2003	12/31/2003
Moody's AA	5.86%	6.11%	6.01%
Merrill Lynch 10+	5.68%	5.88%	5.81%
Merrill Lynch 15+	5.78%	5.99%	5.97%

I apologize for the delay. Please let me know if you have questions.

Regards,
Teresa

Teresa M. Medeiros, ASA., MAAA
Senior Associate
PricewaterhouseCoopers, LLP
One International Place
Boston, MA 02110
Ph: (617) 530-4406
FAX (813) 375-8523
Em: teresa.m.medeiros@us.pwc.com

Lisa G. Ullman
12/19/2003 09:10 PM
617 530-4395
Boston - One International Place
US

To: "Farrell, Michael" <Michael_Farrell@nstaronline.com>@INTL
cc: Teresa M Medeiros/US/TLS/PwC@Americas-US, James C Horvath/US/TLS/PwC@Americas-US, Francis Schlosser/US/ABAS/PwC@Americas-US
Subject: Re: 12/31/03 Discount RatesLink

Mike-

How about that Monday January 4. Our office is closed on that Friday and I am not sure how readily available the rates will be on that day any way.

-Lisa

Lisa G. Ullman
PricewaterhouseCoopers LLP
One International Place
Boston, MA 02110
Direct Dial: 617 530-4395
Fax: 813 639-3603
Lisa.G.Ullman@us.pwc.com

PLEASE NOTE THAT EFFECTIVE OCTOBER 17, 2003, MY NEW DIRECT DIAL TELEPHONE AND FAX NUMBERS CHANGED AS FOLLOWS:
PHONE: 617 530-4395
PRIVATE FAX: 813 639-3603

THE MAIN OFFICE NUMBERS HAVE ALSO CHANGED, AS FOLLOWS:
PHONE: 617 530-5000
MAIN FAX: 617 530-5001

"Farrell, Michael" <Michael_Farrell@nstaronline.com>
12/19/2003 08:01 PM

To: Lisa G. Ullman/US/TLS/PwC@Americas-US
cc:
Subject: 12/31/03 Discount Rates

Lisa,

I lost the person's name who sent me the discount rate updates back in October. Could you forward this message so that I could get the year end rates on 1/2? Or at least as much as you have at that point?

Have a great holidays!!

Mike

Farrell, Michael

From: lisa.g.ullman@us.pwc.com
Sent: Monday, August 23, 2004 2:05 PM
To: Michael_Farrell@nstaronline.com
Cc: sean.p.riley@us.pwc.com
Subject: RE: NSTAR substantive plan

Mike-

Just last week there was more on caps. If you see the observation related to the Bell South accounting you will see it may not be as straight forward as we thought earlier.

-Lisa

Lisa G. Ullman
Human Resource Services
PricewaterhouseCoopers LLP
One International Place
Boston, MA 02110
Direct Dial: 617 530-4395
Fax: 813 639-3603
Lisa.G.Ullman@us.pwc.com
http://www.pwc.com/us/hrs

"Farrell, Michael" <Michael_Farrell@nstaronline.com>
07/22/2004 07:47 PM

To Lisa G. Ullman/US/TLS/PwC@Americas-US
cc Sean P Riley/US/ABAS/PwC@Americas-US
Subject RE: NSTAR substantive plan

Thanks Lisa. I think it is safe to say that our caps are definitely subject to collective bargaining. In fact, it is probably one of the hottest strike issues for next year. So, I think our conclusion should stick.

Mike
-----Original Message-----
From: lisa.g.ullman@us.pwc.com [mailto:lisa.g.ullman@us.pwc.com]
Sent: Thursday, July 22, 2004 6:27 PM
To: Michael_Farrell@nstaronline.com
Cc: sean.p.riley@us.pwc.com
Subject: RE: NSTAR substantive plan

I agree- except that the ARM does say that "sometimes it will be difficult to assess whether the caps in the retiree plan are subject to actual bargaining, making the provisions in FAS 106 very difficult to apply in practice. For example, if the employer intends to increase the cap for the effects of general inflation without requiring any quid pro quo reductions in benefits, compensation, or other trade-offs, it would be appropriate to assume related increases in the caps."

-Lisa

Lisa G. Ullman
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"Farrell, Michael" <Michael_Farrell@nstaronline.com>

07/22/2004 05:42 PM

To Lisa G. Ullman/US/TLS/PwC@Americas-US
cc Sean P Riley/US/ABAS/PwC@Americas-US
Subject RE: NSTAR substantive plan

Lisa,

I was able to look at the ARM you referred to at the end of your e-mail by looking it up on Comperio. My reading of 4380.315 is that we should not anticipate any change to the cap in our FAS 106 calculation for our collectively bargained plan. I think it is generally our intention to keep the management plan in line with the union plan goingforward. So, I guess I would make the same conclusion on the management plan.

I guess all this says that for purposes of determining the substantive plan, we should assume that the current collectively bargained cap goes forward.

Mike
-----Original Message-----
From: lisa.g.ullman@us.pwc.com [mailto:lisa.g.ullman@us.pwc.com]
Sent: Thursday, July 15, 2004 11:29 AM
To: Michael Farrell
Cc: sean.p.riley@us.pwc.com
Subject: Fw: NSTAR substantive plan

Mike- see below. (as you can tell I found your email address)

-Lisa

Lisa G. Ullman
Human Resource Services
PricewaterhouseCoopers LLP
One International Place
Boston, MA 02110
Direct Dial: 617 530-4395
Fax: 813 639-3603
Lisa.G.Ullman@us.pwc.com
http://www.pwc.com/us/hrs

----- Forwarded by Lisa G. Ullman/US/TLS/PwC on 07/15/2004 09:19 AM -----

Lisa G. Ullman/US/TLS/PwC

07/13/2004 05:11 PM
617 530-4395
Boston - One International Place
US

To Sean riley
cc
Subject NSTAR substantive plan

Implementation Guide on FAS 106

3. Q--A collectively bargained defined benefit postretirement health care plan of a single employer may stipulate that benefits will be provided for the duration of the collective-bargaining agreement or may imply or explicitly state that benefits are subject to renegotiation upon the expiration of the current collective-bargaining agreement. Past negotiations have resulted in the continuation of the plan, although the plan has been amended at various times. Should the accumulated postretirement benefit obligation (APBO) be measured based only on benefits expected to be paid during the period the current agreement will be in force? [8, 23]

A--No. The APBO should be measured assuming that benefits will be provided beyond the period covered by the current collective-bargaining agreement. Paragraph 8 of Statement 106 states, "Absent evidence to the contrary, it shall be presumed that an employer that has provided postretirement benefits in the past or is currently promising those benefits to employees will continue to provide those future benefits." Thus, like accounting for the substantive plan, the practice of providing postretirement benefits creates a presumption that postretirement benefits will continue to be provided in the future. Unless the most recently negotiated collective-bargaining agreement explicitly states for the first time that the payment of postretirement benefits will be discontinued upon the contract's expiration and that is the expectation of the parties to the agreement, the presumption of an ongoing plan is not overcome by the presence of an expiration date for the present collective-bargaining agreement.

Substantive Plan

6. Q--Can future amendments to a written postretirement health care plan that change the amount of a defined dollar cap be anticipated as part of the substantive plan? [17, 23-25]

A--Yes, if the conditions in paragraphs 24 and 25 of Statement 106 are satisfied. A defined dollar cap is part of an employer's cost-sharing arrangement under which the employer limits the amount it will spend for retiree benefits by defining the maximum dollar amount for each retiree or the retiree group to be applied by the employer toward the cost of retiree benefits. For example, a plan with a defined dollar cap may stipulate that the employer will pay for all retiree health care costs in a year up to a specified dollar limit. A past practice of regular increases (or decreases) in that defined dollar cap may indicate that the cost-sharing provisions of the substantive plan differ from the extant written plan.

7. Q–Is a postretirement health care plan with a defined dollar cap considered to be a plan that provides benefits defined in terms of monetary amounts as discussed in paragraph 26? [16, 17, 26]

A–No. Changes in monetary benefits provided by one plan or changes in the amount of a defined dollar cap on cost sharing for a different plan may need to be anticipated as part of determining what are the substantive plans. However, the nature of the promises for the two plans differs. Benefits for the first plan are defined in monetary amounts, for example, a stipulated dollar amount of life insurance coverage, whereas benefits offered under the defined dollar capped plan are not defined in monetary amounts. Although the cap on the employer's contribution is defined in monetary terms, the benefits are the specified eligible medical claims with payment by the employer being no greater than the amount of that cap. Changes in the types of benefits or the types of health care costs covered by a plan cannot be anticipated.

Excerpts from FAS 106
Measurement of Cost and Obligations

Accounting for the Substantive Plan

23. An objective of this Statement is that the accounting reflect the terms of the exchange transaction that takes place between an employer that provides postretirement benefits and the employees who render services in exchange for those benefits, as those terms are understood by both parties to the transaction. Generally, the extant written plan provides the best evidence of the terms of that exchange transaction. However, in some situations, an employer's **cost-sharing** policy, as evidenced by past practice or by communication of intended changes to a plan's cost-sharing provisions (paragraphs 24 and 25), or a past practice of regular increases in certain monetary benefits (paragraph 26) may indicate that **the substantive plan**-the plan as understood by the parties to the exchange transaction-differs from the extant written plan. The substantive plan shall be the basis for the accounting.

24. Except as provided in paragraph 25, an employer's cost-sharing policy, as evidenced by the following past practice or communication, shall constitute the cost-sharing provisions of the substantive plan if either of the following conditions exist. Otherwise, the extant written plan shall be considered to be the substantive plan.

a. The employer has a past practice of (1) maintaining a consistent level of cost sharing between the employer and its retirees through changes in deductibles, coinsurance provisions, retiree contributions, or some combination of those changes or (2) consistently increasing or reducing the employer's share of the cost of the covered benefits through changes in retired or **active plan participants'** contributions toward their retiree health care benefits, deductibles, coinsurance provisions, out-of-pocket limitations, and so forth, in accordance with the employer's established cost-sharing policy

b. The employer has the ability, and has communicated to affected **plan participants** its intent, to institute different cost-sharing provisions at a specified time or when certain conditions exist (for example, when health care cost increases exceed a certain level).

25. An employer's past practice of maintaining a consistent level of cost sharing with its retirees or consistently increasing or reducing its share of the cost of providing the covered benefits shall not constitute provisions of the substantive plan if accompanied by identifiable offsetting changes in other benefits or compensation [9] or if the employer incurred significant costs, such as work stoppages, to effect that cost-sharing policy.[10] Similarly, an employer's communication of its intent to institute cost-sharing provisions that differ from the extant written plan or the past cost-sharing practice shall not constitute provisions of the substantive plan (a) if the plan participants would be unwilling to accept the change without adverse consequences to the employer's operations or (b) if other modifications of the plan, such as the level of benefit coverage, or providing offsetting changes in other benefits, such as pension benefits, would be required to gain plan participants' acceptance of the change to the cost-sharing arrangement.

26. A past practice of regular increases in postretirement benefits defined in terms of monetary amounts may indicate that the employer has a present commitment to make future *improvements* to the plan and that the plan will provide monetary benefits attributable to prior service that are greater than the monetary benefits defined by the extant written plan. In those situations, the substantive commitment to increase those benefits shall be the basis for the accounting. Changes in the benefits, other than benefits defined in terms of monetary amounts, covered by a postretirement health care plan or by other postretirement benefit plans shall not be anticipated.

27. Contributions expected to be received from active employees toward the cost of their postretirement benefits and from retired plan participants are treated similarly for purposes of measuring an employer's expected postretirement benefit obligation. That obligation is measured as the actuarial present value of the benefits expected to be provided under the plan, reduced by the actuarial present value of contributions expected to be received from the plan participants during their remaining active service and postretirement periods. In determining the amount of the contributions expected to be received from those participants toward the cost of their postretirement benefits, consideration is given to any related substantive plan provisions, such as an employer's past practice of consistently increasing or reducing the contribution rates as described in paragraphs 24 and 25. An obligation to return contributions received from employees who do not attain eligibility for postretirement benefits and, if applicable, any interest accrued on those contributions shall be recognized as a component of an employer's postretirement benefit obligation.

28. Automatic benefit changes [11] specified by the plan that are expected to occur shall be included in measurements of the expected and accumulated postretirement benefit obligations and the service cost component of net periodic postretirement benefit cost. Also, **plan amendments** shall be included in the computation of the expected and accumulated postretirement benefit obligations once they have been contractually agreed to, even if some provisions take effect only in future periods. For example, if a plan amendment grants a different benefit level for employees retiring after a future date, that increased or reduced benefit level shall be included in current-period measurements for employees expected to retire after that date.

FAS106, Footnote 10--By definition, an employer does not have the unilateral right to change a collectively bargained plan. Therefore, if the postretirement benefits are the subject of collective bargaining, the extant written plan shall be the substantive plan unless the employer can demonstrate its ability to maintain (a) a consistent level of cost sharing or (b) a consistent practice of increasing or reducing its share of the cost of the covered benefits in past negotiations without making offsetting changes in other benefits or compensation of the affected plan participants or by incurring other significant costs to maintain that cost-sharing arrangement.

I think there is also something in the ARM that mentions that more than one change may indicate a change in the substantive plan.

-Lisa

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Please make sure you are familiar with the NSTAR Information Systems Acceptable Use Policy.

Title: BellSouth Announces Significant Amendment to FAS 106 Accounting

Author: Murray S. Akresh

Summary: BellSouth announced that due to its history of waiving the caps in its union-negotiated retiree health plan, including its recently completed negotiation, the company will begin accounting under FAS 106, *Employers ' Accounting for Postretirement Benefits Other Than Pensions*, as if there were no caps in the plan. Other employers with a similar history should consider whether any change to their substantive plan is required.

On August 18, 2004, BellSouth issued the following press release:

> "ATLANTA - BellSouth Corporation (NYSE: BLS) announced today that the new terms of the retiree medical benefits plan included in its tentative agreement with the CWA reached on August 7th will result in a change in the calculation of its retiree medical obligation.
>
> The agreement with the CWA contains contractual limits on the company funded portion of retiree medical costs (referred to as "caps"). BellSouth has waived the premiums in excess of the caps during the current and past contract periods and, therefore has not collected contributions from non-management retirees. BellSouth has previously calculated its obligation for non-management retiree medical costs based on the terms of the written agreement with the CWA.
>
> The recent tentative agreement with the CWA includes an increase in the amount of the caps. With this increase, BellSouth will begin recording retiree medical costs as if there were no caps in future periods, effective in the fourth quarter of 2004. The change in the calculation will result in an increase to the retiree medical benefit obligation of approximately $3.3 billion which will be recognized over the average remaining service life of employees. The impact on fourth quarter 2004 earnings per share will be approximately 3 cents to 4 cents per share."

Observation: *Some employers have collectively bargained retiree health care plans that contain caps, dollar-denominated benefits, or other provisions that limit their share of the cost of benefits. In some cases, the limits would have resulted in increased retiree contributions in periods after the current contract expired, but those retiree contributions were not required because each successive contract negotiation increased the limit. Even though the negotiated increases may have occurred as a result of successive contract negotiations, because they generally applied only to the period of each new contract, future waivers and increases were not anticipated when measuring the overall benefit liability. Although paragraph 25 of FAS 106 and footnote 10 to that paragraph suggest that employers with collectively bargained plans should generally consider the written plan to be the substantive plan for purposes of accounting under FAS 106, waiving or increasing limits as part of successive union contract negotiations could be sufficient to establish a substantive plan that differs from the written plan. Discussions with the SEC staff have confirmed this. Employers should assess whether a series of negotiated waivers, increases, or other changes in plan terms* *reflects a sufficient past practice to establish a substantive plan that is different than the written plan.*

Please call Murray Akresh at 646-394-2362, Kevin Hassan at 203-539-4049 or Greg Nicholson at 646-394-4225 with questions on this release.

Attachment

NTCU 04/193

Farrell, Michael

From: sheryl.a.sciaudone@us.pwc.com

Sent: Tuesday, April 20, 2004 7:15 AM

To: daniel_delmonte@nstaronline.com; john_moreira@nstaronline.com; michael_farrell@nstaronline.com

Cc: francis.schlosser@us.pwc.com

Subject: March 2004 SORD

Hi-

Hope all is well. Attached is the January - March 2004 Summary of Reporting Developments.

Sheryl

Sheryl A. Sciaudone
PricewaterhouseCoopers LLP
Assurance and Business Advisory Services
One International Place
Boston, MA 02110
Direct Line : (617) 530- 4265
Right Fax : (813) 375- 7723

PRICEWATERHOUSECOOPERS

ABAS Americas
Summary of Reporting Developments

SUMMARY OF REPORTING DEVELOPMENTS
JANUARY 1, 2004 THROUGH MARCH 31, 2004

FASB Projects

- Business Combinations: Purchase Method Procedures
- Business Combinations: Fresh Start (New Basis) Accounting
- Combinations of Not-for-Profit Organizations
- Combinations Between Mutual Enterprises
- Disclosures about Intangible Assets
- Liabilities and Equity (Phase Two)
- Proposed Amendment to Revise the Definition of a Liability
- Consolidations Policy and Procedures
- Financial Performance Reporting by Business Enterprises
- Revenue Recognition
- Short-term International Convergence
- International Convergence
- Simplification and Codification Project
- Equity-based Compensation
- Qualifying Special-Purpose Entities and Isolation of Transferred Assets
- Clarifying the Criteria for Liability Extinguishment
- Fair Value Measurement
- Cash Balance Pension Plans – Interpretation of FASB Statement No. 87
- Loan Commitments
- Beneficial Interests in Securitized Financial Assets
- Mortgage Servicing Rights at Fair Value
- Interpretation of the Liability Recognition Provisions of Statement 143

FASB Final Pronouncements

- FAS 132, Employers' Disclosures about Pensions and Other Postretirement Benefits (revised 2003)
- FIN 46, Consolidation of Variable Interest Entities (revised 2003)

FASB Staff Positions

EITF Issues

SEC Rule-Making Initiatives and Interpretations

- Final SEC Releases
- Proposed SEC Rules
- Other SEC Rule-making Initiatives, Studies, and Interpretations

PCAOB Rule-Making Initiatives and Interpretations

- Final Releases
- Proposed Releases

AICPA Projects and Pronouncements

- Statements of Position
- AICPA Practice Aids, Toolkits, and Practice Alerts
- Proposed Statements of Position and Practice Aids
- Proposed Statements on Auditing Standards
- Other proposed rules

GASB

GAO

IASB Projects and Pronouncements

IFRIC Interpretations

IFAC/IAASB Pronouncements

Cash Balance Pension Plans – Interpretation of FASB Statement No. 87

In September 2003, the Board added a limited scope project addressing the measurement of liabilities under "cash balance" pension plans. Key objectives of the project will be to define the scope of the project and then to develop a consistent method of measuring the pension obligations. The project's scope is limited to the measurement of costs and liabilities under "cash balance" pension plans with variable interest-crediting rates.

To date, the Board has agreed on a proposed definition of a cash balance pension plan: "A cash balance pension plan is a defined benefit pension plan (as defined in the glossary of Statement 87) that defines the promised employee benefit by reference to a notional account balance. An employee's notional account balance is increased with periodic notional principal credits and notional fixed and/or variable interest or investment credits, and may be increased for other notional ad hoc credits. Upon separation of employment, for any reason, by a fully vested employee, the employee is entitled to the notional account balance as either a lump sum or an actuarially equivalent annuity either immediately or at a future date. Subject to the terms of the plan or regulatory requirements, an employee may be entitled to a settlement amount greater than the notional account balance due to the crediting of future interest (or investment) credits that are not conditioned upon future service."

Additionally, the Board has made the following tentative decisions:

- A hybrid approach will be used for measuring cash balance pension plan obligations under FAS 87. The hybrid approach requires different treatment for cash balance plans with fixed-interest crediting rates and plans with a market or market-related interest-crediting rate. For plans with fixed-crediting rates, employers continue to follow the guidance in FAS 87 which requires employers to project the future value of a plan participant's notional account balance at the fixed, assumed, market, or market-related crediting rate and discount that future value in accordance with paragraph 44 of FAS 87. Employers with a market or market-related interest crediting rate would be measured at the participant's notional account balance without projecting or discounting of future credits.
- A turnover/forfeiture assumption should considered by companies when calculating the pension obligation for variable interest crediting rate plans.
- Upon adoption, entities would perform a new measurement of the projected benefit obligation using the new method and compare it to the calculation under current guidance. The difference in the two methods would be recorded in the income statement as a cumulative-effect-like adjustment.

This project will result in a FASB Interpretation. An exposure draft is expected in late second quarter of 2004 with a final interpretation in the latter half of 2004 with an expected effective date for fiscal years beginning after December 31, 2004.

Project details are available on the FASB's website:
http://www.fasb.org/project/interpretation_st87.shtml

Loan Commitments

In early October 2003, the Board added a limited scope project, the objective of which is to clarify FASB Statement No. 133 (FAS 133), *Accounting for Derivative Instruments and Hedging*

FASB Final Pronouncements

FASB Statement No. 132, Employers' Disclosures about Pensions and Other Postretirement Benefits (revised 2003)

On December 23, 2003 the Financial Accounting Standards Board (FASB or the "Board") released revised FASB Statement No. 132 (FAS 132), *Employers' Disclosures about Pensions and Other Postretirement Benefits*. The revised standard provides required disclosures for pensions and other postretirement benefit plans and is designed to improve disclosure transparency in financial statements. The revised standard replaces existing pension disclosure requirements. Some of the required disclosures include:

- Plan assets by category (i.e., debt, equity, real estate)
- Investment policies and strategies
- Target allocation percentages or target ranges for plan asset categories
- Projections of future benefit payments
- Estimates of future contributions to fund pension and other postretirement benefit plans
- Interim disclosures of items such as (1) net periodic benefit cost recognized during the period, including service cost, interest cost, expected return on plan assets, prior service cost, and gain/loss due to settlement or curtailment and (2) employer contributions paid and expected to be paid, if significantly revised from the amounts previously disclosed.

The requirements of the standard are effective for public entities for fiscal years ending after December 15, 2003 (for calendar year companies, this means in their 2003 year-end financial statements) and for quarters beginning after December 15, 2003, unless otherwise stated in the standard. The standard is effective for nonpublic entities for fiscal years ending after June 15, 2004.

The revised standard, corresponding press release, and a document addressing frequently asked questions (FAQs) are available on the FASB's website: http://www.fasb.org/fas132r.pdf (standard); http://www.fasb.org/project/pensions_faq.pdf (FAQs); http://www.fasb.org/news/nr122303.shtml (press release)

FASB Interpretation No. 46, Consolidation of Variable Interest Entities (Revised 2003)

On January 17, 2003, the Financial Accounting Standards Board (FASB or the "Board") issued FASB Interpretation No. 46, (FIN 46 or the "Interpretation"), *Consolidation of Variable Interest Entities*. FIN 46 was intended to provide guidance in determining (1) whether consolidation is required under the "controlling financial interest" model of Accounting Research Bulletin No. 51 (ARB 51), *Consolidated Financial Statements* (or other existing authoritative guidance) or, alternatively, (2) whether the variable interest model under FIN 46 should be used to account for existing and new entities. However, the guidance contained in FIN 46 for making such a determination resulted in many more questions than it did answers. As a result in July 2003, the FASB added a limited-scope project to its agenda to modify FIN 46. In December 2003, the FASB released a revised version of FIN 46 (hereafter referred to as FIN 46R) clarifying certain aspects of FIN 46 and providing certain entities with exemptions from the requirements of FIN 46.

The variable interest model of FIN 46R was only slightly modified from that contained in FIN 46. The variable interest model looks to identify the "primary beneficiary" (PB) of a variable interest entity (VIE). The PB is the party that is exposed to the majority of the risk or stands to benefit the most from the VIE's activities. A VIE would be required to be consolidated if either of the following conditions are met:

FASB Staff Positions

FASB Staff Positions (FSPs) contain FASB Staff application guidance on a variety of subject matters. Historically, when the staff disseminated such guidance, that guidance was issued via (1) staff implementation guides, (2) FASB staff announcements at meetings of the Emerging Issues Task Force, or (3) "Action Alerts." FSPs are a way to issue application guidance in a consistent manner. FSPs are subject to a formal due process. Board members review proposed and final FSPs prior to issuance and constituents have 30 days from the date that the FSP was posted to the Board's website to respond. Further information regarding FSPs can be found on the FASB's website: http://www.fasb.org/fasb_staff_positions/index.shtml

Final FSPs

FSP No. FAS 106-1, "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003"
On January 12, 2004, the FASB released FASB Staff Position No. FAS 106-1 (FSP 106-1). FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (FAS 106), requires a company to consider current changes in applicable laws when measuring its postretirement benefit costs and accumulated postretirement benefit obligation. However, because (1) uncertainties may exist for plan sponsors surrounding the effect of the provisions of the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the "Act") and (2) certain accounting issues raised by the Act are not addressed by FAS 106, FSP 106-1 allows plan sponsors to elect a one-time deferral of the accounting for the Act. If deferral is elected, the deferral must remain in effect until the earlier of (a) the issuance of guidance by the FASB or (b) the remeasurement of plan assets and obligations subsequent to January 31, 2004. Further, even if an entity elects deferral, certain disclosure requirements are still required.

The FSP is effective for interim and annual financial statements of fiscal years ending after December 7, 2003. The final FSP can be accessed from the Board's website: http://www.fasb.org/fasb_staff_positions/fsp_fas106-1.pdf

FSP FAS 150-3: *Effective Date for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150 (FAS 150), "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity."*
The final FSP (1) affects how public and nonpublic entities classify, measure, and disclose certain mandatorily redeemable noncontrolling interests associated with finite-lived subsidiaries and mandatorily redeemable financial instruments and (b) requires entities that have already adopted FAS 150 to rescind the adoption of certain provisions of FAS 150 and to permit them to present the adoption of the FSP either by restating previously issued financial statements or as a cumulative effect in the period of adoption.

The final FSP is located on the FASB's website:
http://www.fasb.org/fasb_staff_positions/fsp_fas150-3.pdf

FSP FIN 46(R)-1, *Reporting Variable Interests in Specified Assets of Variable Interest Entities as Separate Variable Interest Entities under Paragraph 13 of FASB Interpretation No. 46 (revised December 2003)(" FIN 46(R)"), "Consolidation of Variable Interest Entities"*
On February 12, 2004, the FASB released this FSP to replace FSP FIN 46-2 as a result of the release of FIN 46R in December 2003. This FSP states that a specified asset of a variable

assets as stated in FAS 141 and FAS 142. Comments are due April 16, 2004. The proposed FSP is available on the FASB's website:
http://www.fasb.org/fasb_staff_positions/prop_fsp_fas141-a&fas142-a.pdf

Proposed FSP FAS 106-b, Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003
FSP 106-b provides guidance on the accounting for the effects of the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the "Act"), for employers that sponsor postretirement health care plans that provide prescription drug benefits. Additionally, this FSP requires certain disclosures addressing the effect of the federal subsidy provided by the Act. Upon final approval, the guidance provided in this FSP will supersede the guidance detailed in FSP FAS 106-1, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003.*

Comments are due April 12, 2004 and the proposed FSP is available on the FASB's website:
http://www.fasb.org/fasb_staff_positions/prop_fsp_fas106-b.pdf

Proposed FSP FAS 129-a, *Disclosure Requirements under FAS 129 Relating to Contingently Convertible Financial Instruments*
On February 25, 2004 the FASB released for public comment FASB Staff Position No. 129-a. FSP 129-a states that all contingently convertible financial instruments fall within the scope of the disclosure requirements of FAS 129. Such contingently convertible financial instruments include those for which the contingent-conversion requirements have not been met, as well as those that are excluded from the calculation of diluted earnings-per-share.

Comments were due March 26, 2004. FSP 129-a is posted to the Board's website:
http://www.fasb.org/fasb_staff_positions/prop_fsp_fas129-a.pdf

Proposed FSP, *Applicability of FASB Statement No. 143, Accounting for Asset Retirement Obligations, to Legislative Requirements on Property Owners to Remove and Dispose of Asbestos or Asbestos-Containing Materials*
This proposed FSP addresses FASB Statement No. 143 (FAS 143), *Accounting for Asset Retirement Obligations*, applicability to the removal or disposal of asbestos or asbestos-containing material. The proposed FSP states that the legal obligation to remove or dispose of asbestos when a building is either renovated or demolished is an asset retirement obligation that should be recognized as a liability in accordance with FAS 143 upon the existence of the asbestos.

Comments on this FSP were due by August 13, 2003 and the proposed FSP can be found on the Board's website: http://www.fasb.org/fasb_staff_positions/06-27-03a_prop_fsp.pdf

The FASB staff has evaluated the comment letters received on this FSP. Because of the diverse views in those comment letters, the FASB staff decided to withdraw the proposed FSP and address this issue and broader related issues in the FASB project entitled, *Interpretation of the Liability Recognition Provisions of Statement 143.* See above for details concerning this project.

Proposed FSP FAS 46(R)-a, Technical Correction of FIN 46R Relating to Its Effects on Question No. 12 of EITF Issue No. 96-21, "Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities"
The proposed FSP states that Appendix F of FIN 46R fully nullified Question 12 of EITF 96-21. However, such notification was incorrect and should have stated that the "nullification should

Farrell, Michael

From: lisa.g.ullman@us.pwc.com
Sent: Wednesday, October 27, 2004 5:21 PM
To: Michael_Farrell@nstaronline.com
Subject: RE: NStar

The benchmark rates are longer term and short term rates we hear about all the time and long term rates often change differently.

Teresa moved to CT for a love interest and is working at a small firm near Hartford.

-Lisa

Lisa G. Ullman
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Lisa.G.Ullman@us.pwc.com
http://www.pwc.com/us/hrs

"Farrell, Michael" <Michael_Farrell@nstaronline.com>
10/27/2004 04:11 PM

To Lisa G. Ullman/US/TLS/PwC@Americas-US
cc
Subject RE: NStar

Thanks Lisa. I think I can figure it out. I'm surprised how much lower the benchmark rates are.

What happened to Teresa?

Mike

From: lisa.g.ullman@us.pwc.com [mailto:lisa.g.ullman@us.pwc.com]
Sent: Wednesday, October 27, 2004 3:19 PM
To: michael_Farrell@NStaronline.com
Cc: sheryl.a.sciaudone@us.pwc.com
Subject: Fw: NStar

Mike-

I hope this is helpful. Please call if the format doesn't come through correctly.

-Lisa

----- Forwarded by Lisa G. Ullman/US/TLS/PwC on 10/27/2004 03:17 PM -----

PRICEWATERHOUSECOOPERS

FAS 87/106 Interest Rate Guidance -- September 2004

Interest Rates
10/06/2004

Interest Rate Guidance

Interest rate yields for use in selecting discount rates under FASB Statement Nos. 87/106.

Treasuries

	Dec 2000	Dec 2001	Dec 2002	Sep 2003	Dec 2003	Aug 2004	Sep 2004
10 Year (A) Rate on last business day	5.12	5.07	3.83	3.96	4.27	4.13	4.14
30 Year (A) Rate on last business day	5.46	5.48	N/A	N/A	N/A	N/A	N/A
1-10 Year Composite (B) Rate on last business day	5.24	3.64	2.12	2.09	2.46	2.85	2.98
10+ Year Composite (B) Rate on last business day	5.54	5.65	4.66	4.68	4.91	4.75	4.72
High Quality (Aaa-Aa) Corporate Bonds							
1-10 Year Composite (C) Rate on last business day	6.33	4.82	3.38	3.07	3.35	3.58	3.65
10+ Year Composite (C) Rate on last business day	7.30	6.88	6.00	5.68	5.81	5.68	5.63
15+ Year (C) Rate on last business day	7.37	6.94	6.13	5.78	5.97	5.80	5.73
Moody's Aa rated corporate bond yield (D) Rate on last business day	7.41	7.10	6.52	5.86	6.01	5.81	5.73
Citigroup pension liability index (E) Rate on last business day	7.27	6.90	6.05	5.87	6.00	5.77	5.70

Footnotes:

(A) Federal Reserve Statistical Release.

(B) Wall Street Journal - Merrill Lynch Bond Index.

(C) Bloomberg Service - Merrill Lynch AAA/AA Bond Index, YTM Semi-Annual
(May not match Wall Street Journal, which is on YTW basis and mid-afternoon pricing)

(D) Factiva - Interactive Service.

(E) Citigroup - Pension Liability Index

If you have any comments, questions or suggestions regarding these guidelines or if you require other historic rates, please call Stephanie Spruyt at 646-394-2002 or Murray Akresh at 646-394-2362.

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http://www.pwc.com/us/hrs

----- Forwarded by Lisa G. Ullman/US/TLS/PwC on 10/27/2004 03:05 PM -----

Sheryl A Sclaudone/US/ABAS/PwC

10/27/2004 01:50 PM
(617) 530- 4265
Boston

To Lisa G. Ullman/US/TLS/PwC@Americas-US
cc
Subject NStar

Hi Lisa

Hope all is well. Mike Farrell stopped by and is looking for the discount rate/information as of 9/30/04 for a presentation for tomorrow. I am sorry this is last minute, but he just asked me today.

I know Teresa used to send him the information and I am not sure if I have the tools to pull it from.

I would greatly appreciate if you can send us the information as soon as you can today.

Thank you

Sheryl A. Sclaudone | PricewaterhouseCoopers LLP | Assurance
One International Place | Boston, MA 02110
Office: (617) 530-4265 | Fax: (813) 375-7723 | Cell: (617) 827-8690

Please make sure you are familiar with the NSTAR Information Systems Acceptable Use Policy.

Farrell, Michael

From: lisa.g.ullman@us.pwc.com
Sent: Thursday, July 15, 2004 11:29
To: Michael Farrell
Cc: sean.p.riley@us.pwc.com
Subject: Fw: NSTAR substantive plan

Mike- see below. (as you can tell I found your email address)

-Lisa

Lisa G. Ullman
Human Resource Services
PricewaterhouseCoopers LLP
One International Place
Boston, MA 02110
Direct Dial: 617 530-4395
Fax: 813 639-3603
Lisa.G.Ullman@us.pwc.com
http://www.pwc.com/us/hrs

----- Forwarded by Lisa G. Ullman/US/TLS/PwC on 07/15/2004 09:19 AM -----

Lisa G. Ullman/US/TLS/PwC

07/13/2004 05:11 PM
617 530-4395
Boston - One International Place
US

To Sean riley
cc
Subject NSTAR substantive plan

Implementation Guide on FAS 106

3. Q—A collectively bargained defined benefit postretirement health care plan of a single employer may stipulate that benefits will be provided for the duration of the collective-bargaining agreement or may imply or explicitly state that benefits are subject to renegotiation upon the expiration of the current collective-bargaining agreement. Past negotiations have resulted in the continuation of the plan, although the plan has been amended at various times. Should the accumulated postretirement benefit obligation (APBO) be measured based only on benefits expected to be paid during the period the current agreement will be in force? [8, 23]

A--No. The APBO should be measured assuming that benefits will be provided beyond the period covered by the current collective-bargaining agreement. Paragraph 8 of Statement 106 states, "Absent evidence to the contrary, it shall be presumed that an employer that has provided postretirement benefits in the past or is currently promising those benefits to employees will continue to provide those future benefits." Thus, like accounting for the substantive plan, the practice of providing postretirement benefits creates a presumption that postretirement benefits will continue to be provided in the future. Unless the most recently negotiated collective-bargaining agreement explicitly states for the first time that the payment of postretirement benefits will be discontinued upon the contract's expiration and that is the expectation of the parties to the agreement, the presumption of an ongoing plan is not overcome by the presence of an expiration date for the present collective-bargaining agreement.

Substantive Plan

6. Q--Can future amendments to a written postretirement health care plan that change the amount of a defined dollar cap be anticipated as part of the substantive plan? [17, 23-25]

A–Yes, if the conditions in paragraphs 24 and 25 of Statement 106 are satisfied. A defined dollar cap is part of an employer's cost-sharing arrangement under which the employer limits the amount it will spend for retiree benefits by defining the maximum dollar amount for each retiree or the retiree group to be applied by the employer toward the cost of retiree benefits. For example, a plan with a defined dollar cap may stipulate that the employer will pay for all retiree health care costs in a year up to a specified dollar limit. A past practice of regular increases (or decreases) in that defined dollar cap may indicate that the cost-sharing provisions of the substantive plan differ from the extant written plan.

7. Q--Is a postretirement health care plan with a defined dollar cap considered to be a plan that provides benefits defined in terms of monetary amounts as discussed in paragraph 26? [16, 17, 26]

A–No. Changes in monetary benefits provided by one plan or changes in the amount of a defined dollar cap on cost sharing for a different plan may need to be anticipated as part of determining what are the substantive plans. However, the nature of the promises for the two plans differs. Benefits for the first plan are defined in monetary amounts, for example, a stipulated dollar amount of life insurance coverage, whereas benefits offered under the defined dollar capped plan are not defined in monetary amounts. Although the cap on the employer's contribution is defined in monetary terms, the benefits are the specified eligible medical claims with payment by the employer being no greater than the amount of that cap. Changes in the types of benefits or the types of health care costs covered by a plan cannot be anticipated.

Excerpts from FAS 106

Measurement of Cost and Obligations

Accounting for the Substantive Plan

23. An objective of this Statement is that the accounting reflect the terms of the exchange transaction that takes place between an employer that provides postretirement benefits and the employees who render services in exchange for those benefits, as those terms are understood by both parties to the transaction. Generally, the extant written plan provides the best evidence of the terms of that exchange transaction. However, in some situations, an employer's **cost-sharing** policy, as evidenced by past practice or by communication of intended changes to a plan's cost-sharing provisions (paragraphs 24 and 25), or a past practice of regular increases in certain monetary benefits (paragraph 26) may indicate that the **substantive plan**-the plan as understood by the parties to the exchange transaction-differs from the extant written plan. The substantive plan shall be the basis for the accounting.

24. Except as provided in paragraph 25, an employer's cost-sharing policy, as evidenced by the following past practice or communication, shall constitute the cost-sharing provisions of the substantive plan if either of the following conditions exist. Otherwise, the extant written plan shall be considered to be the substantive plan.

a. The employer has a past practice of (1) maintaining a consistent level of cost sharing between the employer and its retirees through changes in deductibles, coinsurance provisions, retiree contributions, or some combination of those changes or (2) consistently increasing or reducing the employer's share of the cost of the covered benefits through changes in retired or **active plan participants'** contributions toward their retiree health care benefits, deductibles, coinsurance provisions, out-of-pocket limitations, and so forth, in accordance with the employer's established cost-sharing policy

b. The employer has the ability, and has communicated to affected **plan participants** its intent, to institute different cost-sharing provisions at a specified time or when certain conditions exist (for example, when health care cost increases exceed a certain level).

25. An employer's past practice of maintaining a consistent level of cost sharing with its retirees or consistently increasing or reducing its share of the cost of providing the covered benefits shall not constitute provisions of the substantive plan if accompanied by identifiable offsetting changes in other benefits or compensation [9] or if the employer incurred significant costs, such as work stoppages, to effect that cost-sharing policy.[10] Similarly, an employer's communication of its intent to institute cost-sharing provisions that differ from the extant written plan or the past cost-sharing practice shall not constitute provisions of the substantive plan (a) if the plan participants would be unwilling to accept the change without adverse consequences to the employer's operations or (b) if other modifications of the plan, such as the level of benefit coverage, or providing offsetting changes in other benefits, such as pension benefits, would be required to gain plan participants' acceptance of the change to the cost-sharing arrangement.

26. A past practice of regular increases in postretirement benefits defined in terms of monetary amounts may indicate that the employer has a present commitment to make future *improvements* to the plan and that the plan will provide monetary benefits attributable to prior service that are greater than the monetary benefits defined by the extant written plan. In those situations, the substantive commitment to increase those benefits shall be the basis for the accounting. Changes in the benefits, other than benefits defined in terms of monetary amounts, covered by a postretirement health care plan or by other postretirement benefit plans shall not be anticipated.

27. Contributions expected to be received from active employees toward the cost of their postretirement benefits and from retired plan participants are treated similarly for purposes of measuring an employer's expected postretirement benefit obligation. That obligation is measured as the actuarial present value of the benefits expected to be provided under the plan, reduced by the actuarial present value of contributions expected to be received from the plan participants during their remaining active service and postretirement periods. In determining the amount of the contributions expected to be received from those participants toward the cost of their postretirement benefits, consideration is given to any related substantive plan provisions, such as an employer's past practice of consistently increasing or reducing the contribution rates as described in paragraphs 24 and 25. An obligation to return contributions received from employees who do not attain eligibility for postretirement benefits and, if applicable, any interest accrued on those contributions shall be recognized as a component of an employer's postretirement benefit obligation.

28. Automatic benefit changes [11] specified by the plan that are expected to occur shall be included in measurements of the expected and accumulated postretirement benefit obligations and the service cost component of net periodic postretirement benefit cost. Also, **plan amendments** shall be included in the computation of the expected and accumulated postretirement benefit obligations once they have been contractually agreed to, even if some provisions take effect only in future periods. For example, if a plan amendment grants a different benefit level for employees retiring after a future date, that increased or reduced benefit level shall be included in current-period measurements for employees expected to retire after that date.

FAS106, Footnote 10--By definition, an employer does not have the unilateral right to change a collectively bargained plan. Therefore, if the postretirement benefits are the subject of collective bargaining, the extant written plan shall be the substantive plan unless the employer can demonstrate its ability to maintain (a) a consistent level of cost sharing or (b) a consistent practice of increasing or reducing its share of the cost of the covered benefits in past negotiations without making offsetting changes in other benefits or compensation of the affected plan participants or by incurring other significant costs to maintain that cost-sharing arrangement.

I think there is also something in the ARM that mentions that more than one change may indicate a change in the substantive plan.

-Lisa

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LABOR COSTS AND EMPLOYEE BENEFITS 4380
POSTRETIREMENT BENEFITS OTHER THAN PENSIONS (OPEB)

Update Notice: The last comprehensive update of this Manual section was as of October 31, 2003.

Authoritative and Non-Authoritative Literature

FAS 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions," prescribes the methodology to be applied for measuring and recording OPEB costs and obligations. "OPEB" is the acronym for "other postemployment benefits" and is used herein to describe postretirement benefits other than pensions that are covered by FAS 106.

The FASB Staff Implementation Guide on FAS 106 (FASB Q&A.106), "A Guide to Implementation of Statement 106 on Employers' Accounting for Postretirement Benefits Other Than Pensions," was revised in September 2001. Selected questions and answers from the guide are noted herein. The Guide's Table of Contents and Appendix contain a comprehensive list of issues addressed.

Two firm publications, "Implementing FASB Statement 106: A Management Guide," and "OPEB: The New Direction: Understanding and Applying FAS 106," also provide guidance with respect to many of the matters discussed herein and include sample calculations and a section describing typical plans and types of changes that employers may make to their plans in an effort to control OPEB costs. Funding considerations are also discussed. The publications are contained in Comperio,the firm's electronic reference tool of authoritative and non-authoritative accounting literature.

The accounting concept underlying FAS 106 is an elementary one: an employer's promise to provide retirees with postretirement benefits represents a form of deferred compensation. The cost of those benefits should be recognized systematically over employees' service periods. FAS 106's methodology for measuring and recording OPEB costs and obligations is similar in many respects to FAS 87, "Employers' Accounting for Pensions," and FAS 88, "Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits." As a result of the similarities, the FASB Staff Implementation Guides on FAS 87 and FAS 88 (FASB Q&A.87 and FASB Q&A.88, respectively) contain guidance that is relevant to many of the issues that employers may face when accounting for OPEB costs and obligations.

Further, because of the similarities between accounting for pensions and accounting for other postretirement benefits, ARM 4270, which addresses employers' accounting for pensions, can be useful in answering questions on employer's accounting for postretirement benefits other than pensions.

.1 ACCOUNTING DEFINITION OF THE PLAN

The most common OPEB plan is a promise to provide in-kind health care benefits to retirees. The promise may be either to reimburse retirees for their payments for health care services or to provide the services to them directly. Although the focus of FAS 106 is on retiree health care benefits, OPEB comprise all forms of benefits other than pensions provided to retirees and their spouses, dependents, and beneficiaries. These include life insurance offered outside of a pension plan, legal and tax services, tuition assistance, day care services, and housing assistance.

For FAS 106 purposes, a postretirement benefit plan generally exists whenever an employer promises to provide benefits other than pension benefits to employees after they retire. Those to whom a promise has been made may include current and former employees (including retirees and disabled employees). The benefits may extend to the employees' spouses, dependents, and beneficiaries. The provisions of FAS 106 do not extend to other postemployment benefits arising from circumstances other than retirement. Such benefits, which are payable after employment ends but before retirement begins (e.g., layoff benefits), are covered by FAS 112, "Employers' Accounting for Postemployment Benefits" (see ARM 4390).

Substance over form

Postretirement benefit plans are not limited to legally enforceable contracts. Any arrangement other than pensions that is in substance a postretirement benefit plan, regardless of its form, is covered by FAS 106. The plan may be written, or there may be an unwritten promise to provide benefits that arise from a practice of paying benefits or from oral representations made to employees. In certain instances, the written plan may embody the entire agreement, but may be supplemented by provisions that exist in substance due to past practice or an employer's intended actions as communicated to participants.

Retiree "pay all" plans may still require recognition of an OPEB obligation

An employer may sponsor a health care plan permitting retirees to continue participation on a "pay all" basis (i.e., by requiring a retiree contribution based on the estimated per capita cost of coverage). In some plans, retiree contributions are established based on the average per capita cost of coverage for the entire plan group (i.e., actives and retirees), rather than the per capita cost for retirees only. While not readily apparent, this practice provides a postretirement benefit to the extent that the retirees are contributing less than the actual costs someone their age would incur for health care because retirees as a group usually incur medical costs that are greater than the average cost for active employees and retirees. The employer's OPEB obligation would be calculated as the portion of the future cost of retiree health care benefits not recovered through retiree contributions, Medicare, or other reimbursements. (Refer to footnote 14 in FAS 106, par. 35 and FASB Q&A.106, question 10.)

.11 Determining the "Substantive Plan"

An objective of FAS 106 is that the accounting for OPEB reflects the substance of the arrangement between the employer and employee rather than its form. Therefore, FAS 106 requires employers to measure the OPEB obligation using the provisions that are understood by both the employer and employee to be the operative plan terms, even when such provisions are not embodied in the written plan.

The consideration of certain cost sharing practices (i.e., policies that reduce the employer's cost) that are not embodied in the written plan is subject to limitations. FAS 106, par. 24 defines the conditions that permit a past practice or communication to qualify as features of the substantive plan. FAS 106, par. 25 discusses certain exceptions to those conditions.

FAS 106, par. 25, fn 10 discusses collectively bargained plans, noting that because an employer does not have the unilateral right to change such a plan, the written plan would typically constitute the substantive plan. An exception exists where the employer can demonstrate its ability to maintain a consistent level of cost sharing or a consistent level of reducing its share of costs in past negotiations without making offsetting changes in other compensation benefits or incurring other significant costs. Many companies have added per capita limitations or other types of "caps" on annual OPEB benefits as part of collectively bargained plans. Even if these caps are not expected to come into play during the term of the contract, they form part of the substantive plan in determining the estimated benefit obligation.

.111 Defining a "past practice"

The term "past practice" is not defined in FAS 106, although FAS 106, par. 176, Appendix A states that "Such a past practice would be indicated when the nature of the change and duration of the past practice are sufficient to warrant a presumption that it is understood by the plan participants." Each situation must be considered individually.

.112 Defining "communication"

FAS 106 does not specify the form of communication required to institute different cost-sharing provisions. It simply notes that plan terms must be mutually understood by an employer and the affected plan participants. Any form of communication that establishes this understanding, whether written or oral, formal or informal, would seem to satisfy this requirement.

.113 Limitations on the types of practices that can be incorporated into the substantive plan

FAS 106's requirement to consider past practice and communication to participants of intended changes is limited to a plan's cost-sharing provisions. Changes in other plan provisions, such as those that alter the types of benefits covered by the plan or the eligible participants, would not qualify for consideration under FAS 106, par. 24.

For example, an employer may have an established practice of limiting its annual increase in the cost of health coverage to 5%, accomplished by various methods, including limiting hospital room coverage, eliminating surgical benefits for certain procedures, reducing dependent coverage, and changing cost-sharing provisions of the plan. The ability of the employer to maintain this level of cost increase in the future through these means is not reasonably predictable, because reductions in coverage and eligible participants cannot be made indefinitely. Therefore, in calculating the OPEB obligation, a presumption could not be made that the annual increase in the employer's cost of providing retiree health care coverage would always be limited to 5%. However, within the actions taken to achieve the 5% limitation, the cost-sharing actions shall be considered part of the substantive plan if the employer has a past practice of cost-sharing (e.g., raising deductibles or retiree contributions or changing co-insurance provisions) or has the ability (and has communicated to affected plan participants its intent) to institute different cost sharing provisions.

.114 "Negative" plan amendments

The significant increase in the cost of providing health care benefits to retirees has resulted in many enterprises amending the terms of their "promise" by reducing benefits, which is considered a "negative plan amendment." There are presently no federal laws regulating OPEB benefits. However, reductions in benefits, whether made pursuant to a written plan or as a matter of historical procedure, have sometimes resulted in litigation against the enterprise on behalf of the retirees. Such litigation may seek to retroactively reinstate the prior level of benefits.

The possibility that negative plan amendments might be later reversed as a result of litigation or the threat thereof should be carefully considered. If it is probable (as used in FAS 5, "Accounting for Contingencies") that the negative plan amendment will be rescinded, the OPEB obligation should not be reduced by the effects of the negative plan amendment. If rescission is not probable, the facts and circumstances may represent a contingent liability requiring disclosure pursuant to FAS 5.

Further, the effects of a plan amendment, whether positive or negative, should be considered when measuring the OPEB obligation only if it has been communicated to plan participants at the date the amendment is adopted or within a reasonable period of time thereafter (i.e., within the time period that would ordinarily be required to prepare information about the amendment and disseminate it to employees and retirees). The answer to FASB Q&A.106, question 23 does not define "a reasonable period of time." It does, however, indicate that one year after the date of amendment is not a reasonable period of time. We believe that recognition of the amendment at adoption is appropriate if management's actions demonstrate that it intends to communicate the changes in the normal time period typical for communications of other amendments of a similar nature or magnitude. Deferring the communication to the annual date on which plan changes and other information are communicated would generally not meet the "reasonable period of time" condition. As indicated in FASB Q&A.106, if the delay in communication is unreasonable, the existing written plan continues to be the substantive plan that would be accounted for because it represents the last plan whose terms were mutually understood by the employer and plan participants.

FAS 106, par. 25 also states that an employer's communication of its intent to institute cost-sharing provisions that differ from the written plan or prior practice shall not constitute the substantive plan if the plan participants would be unwilling to accept the change without adverse consequences to operations or if other modifications to the plan or offsetting benefits would be required to gain participants' acceptance.

If a client is considering accounting for the adoption of a plan change without communicating the change in the period of adoption, consultation with the Accounting Consulting Services Group is required.

.3 DEFINED BENEFIT PLANS

.31 Measuring the OPEB Obligation

FAS 106 identifies a defined benefit postretirement plan as a plan that defines the postretirement benefits in terms of (a) monetary amounts or (b) benefit coverage to be provided. For benefits defined in terms of health care services rather than specific dollar amounts, an employer will have to accumulate and analyze historical medical claim data. This task is necessary: (1) to identify current (or base period) per capita claims costs in sufficient detail so that they may be used as a base for projecting future costs; and (2) to develop appropriate actuarial assumptions as to future health care cost trends.

Once estimated, the future per capita claims costs are used together with plan demographics to determine the amount and timing of expected future benefits to be provided under the substantive plan. Actuarial assumptions similar to the types used for pensions are used to determine the probability of payment; discount rates are applied to future years' estimated benefits to determine the present value of those payments. The resulting amount represents the expected postretirement benefit obligation (EPBO) and is the basis for calculating the OPEB obligation incurred to date (referred to as the APBO, or accumulated postretirement benefit obligation) and net periodic OPEB cost.

Employers with plans providing defined dollar benefits rather than in-kind health care services will not need to accumulate and analyze historical claims cost data or develop assumptions as to future health care cost trends. For such plans, the process for estimating future benefits will be similar to that for defined benefit pension plans.

.311 Per capita cost

For benefits defined in terms of health care coverage, future benefit payments to be made by an employer to or on behalf of each plan participant must be estimated. These future benefit payments are referred to in FAS 106 as the assumed "net incurred claims cost at each age" and would be derived by estimating the assumed (gross) per capita claims costs by age and reducing it by the effects of Medicare and coverage by other providers and the effects of the plan's cost-sharing provisions.

Separate base period gross per capita claims costs should be developed at each age, and possibly also by sex, geographic location, and type of medical service (e.g., hospital care, physician services, and drugs). Materiality considerations as to possible effects on the APBO and periodic service cost will influence the level of detail at which base period per capita costs need to be developed.

Trend rates are estimated for each future year through the last year the youngest current plan participant or dependent is expected to receive benefits (see ARM 4380.313). These rates are then applied to the base period cost for each of the applicable years during retirement to estimate the aggregate future claims cost during retirement. For example, to estimate the future cost of retiree health care coverage at age 70 for an employee who is 45 years old in 2002, the annual trend rates for 2002 through 2027 would be applied to the base period 2002 cost for a 70 year old. Some plans incorporate "caps" that limit the maximum OPEB benefit payable. See ARM 4380.315 for a discussion of these plans.

Under existing law, certain health care benefits are available to individuals age 65 and older through Medicare. The estimation of the employer's future cost, therefore, includes a reduction of the assumed gross per capita claims cost to the extent that plan benefits are reduced for amounts expected to be paid through Medicare. Similarly, the assumed gross per capita claims cost is reduced by expected reimbursements of costs by others, for example, by a retiree's spouse's OPEB plan sponsored by another enterprise. The Medicare and other provider reimbursement amounts must be estimated for each future year using the level of benefit coverage provided under the present law and existing plan. Only enacted changes in the law or amendments to other providers' existing plans that take effect in future periods are to be considered in current period measurements for benefits expected to be provided in those future periods. Future changes in the law or other provider plans cannot be anticipated.

Participant cost-sharing amounts would also reduce the assumed gross per capita claims cost. These components are calculated by applying the cost-sharing provisions embodied in the employer's substantive plan to each year's projected assumed gross per capita claims cost. Certain plans require contributions by active employees toward their postretirement benefit coverage. In those cases, the actuarial present value of such contributions would reduce the actuarial present value of the aggregate assumed incurred claims cost.

The assumed net incurred claims cost at each age during the retirement period is estimated for each employee/retiree participating in the plan and is then applied, along with actuarial assumptions similar to those used in pension calculations, to estimate benefit payments for the entire participant group.

Internal and external costs directly associated with administering the plan would be accrued as a component of the assumed gross claims cost, if significant. FAS 106 does not elaborate on the types of direct costs to be considered. We believe they should be limited to incremental costs. Therefore, such costs as employee salaries and general and administrative expenses that would have been incurred, even if no OPEB plan existed, would not be included in assumed gross claims cost.

.312 Demographics and assumptions

The per capita claims costs, developed as described at ARM 4380.311, are applied along with plan participant demographics to estimate future benefit payments. Therefore, employers will typically accumulate employee and retiree information in categories consistent with their per capita claims cost data. A complete listing of individuals expected to be eligible for benefits under the plan is accumulated, including active employees eligible or expected to become eligible, former employees who are eligible for benefits under the retiree plan (including disabled individuals), and retirees. Some of this census data is also accumulated for purposes of the pension plan, for example:

- Date of birth,
- Sex,
- Date of hire,
- Business unit,
- Hourly/salaried employee,
- Marital status and spouse's date of birth (if spousal coverage is provided),
- Retirement date, and
- Salary (if plan is pay-related).

Data that may be required and would be unique to OPEB include:

- Plan option selected (e.g., indemnity plan, HMO, or preferred provider organization),
- Coverage offered through spouse's or other plan,
- Dependents and their dates of birth (if dependent coverage is provided), and
- Geographic location of employees and retirees.

Some of the OPEB census data may not be available. For example, companies may not have updated information on dependents or their birth dates, or the existence of coverage through a spouse's plan. Depending on the nature and level of OPEB coverage, such data could be significant to the OPEB If not currently accessible, actuarial estimates of this data should be made.

.313 Health care cost trend rates

The health care cost trend rates to be applied to the base period gross per capita claims cost represent the expected annual rates of change in the gross cost of the specific health care benefits provided under the plan. FAS 106 requires that the rates be developed using past and present health care cost trends, which would implicitly consider estimates of health care inflation, changes in health care utilization and delivery patterns, technological advances, and changes in the health status of plan participants. It also notes that different types of services, for example, hospital and dental care, may require different trend rates. Estimating rates of increase in health care costs into the distant future requires the exercise of judgment.

The effect of the discount factors used to present value future estimated health care costs can mitigate the dollar impact of inaccuracies in the trend rate estimates, especially distant years' estimates. In addition, FAS 106 permits differences between estimates and actual experience to be amortized prospectively. See ARM 4380.46.

Developing future trend rates begins with an analysis of past years' trend rates. If estimates of the assumed per capita claims cost are made for various categories of health care services, for example, hospital care and dental care, separate trend rates would be developed for each such category. This historical analysis would typically be developed from the same source as the data used for developing the base period gross per capita claims cost discussed earlier. However, whereas base period gross per capita costs may require the accumulation of only several years of data, in analyzing historical trends employers may find it appropriate to review data for additional years. On the other hand, recent plan changes may reduce the usefulness of historical data.

In some cases, for example, where historical data is not available or is not considered reliable or indicative of the plan's expected experience, trend rates can be developed from per capita costs of other employers, adjusted to best reflect the terms of the employer's plan and the demographics of the participants.

Prediction of future health care trends should not rely on history alone. The analysis of past trends is supplemented by assumptions about the magnitude and direction of changes in future trend rates from rates. In developing estimates of future trends, it is important that preliminary estimates be tested against general inflation and productivity estimates to ensure that health care remains logically related to other economic sectors. This approach is similar to that used in developing future projections of the Consumer Price Index.

FAS 106, par. 39 offers general guidance for developing the trend rates assumption:

> It is appropriate for that assumption to reflect changes in health care cost trend rates over time. For example, the health care cost trend rates may be assumed to continue at the present level for the near term, or increase for a period of time, and then grade down over time to an estimated health care cost trend rate ultimately expected to prevail.

As in any actuarial valuation, a number of iterations may be required before the most probable assumptions are identified. These alternative scenarios may vary by the length of time the near-term trend pattern is expected to continue and the timing and degree of the grading down to the ultimate trend rate. It may not be unrealistic to assume that at some point, the trend rate would approach the forecasted general inflation rate.

In the periodic reporting of OPEB cost, the difference between actual versus estimated rates of change in per capita claims cost and between actual versus expected benefit payments in the year just completed will result in actuarial gains or losses. Accounting for these gains or losses is discussed at ARM 4380.46. In addition, the most recent trend rate experience should be considered in the development of the trend rate estimates to be used in the following period's measurement of the OPEB obligation.

Rates of increase in health care costs experienced in the past and estimated to occur in the future will vary from employer to employer, within each enterprise, and from plan to plan, depending upon factors such as the:

- Actual retiree health care inflation experienced in prior years,
- Expected cost increases (e.g., premium increases on the part of the insurance carrier),
- Type of health care coverage offered (e.g., traditional indemnity, HMO, or PPO),
- Specific categories of services covered (e.g., major medical or basic medical),
- Demographics of the covered group (e.g., age, sex, and geographic location), and
- Effectiveness of cost and utilization controls (e.g., contracts with specified providers, catastrophic case management and hospital pre-admission reviews).

Accordingly, and consistent with the base period per capita claims cost assumption, the health care cost trend rates assumption must be developed on a plan-specific basis.

The SEC staff pays particular attention to assumed health care cost trend rates because rising health care costs will have a significant impact on postretirement benefit obligations of employers and the periodic expense related to those obligations. Recent trends in health care costs should prompt employers to reevaluate in their next actuarial valuation the assumptions as of the measurement date that they use when measuring postretirement expenses and obligations.

.314 Other assumptions used in estimating the OPEB obligation

Although the per capita claims cost, health care cost trend rates and other health care related assumptions are unique to OPEB, other actuarial assumptions used in calculating the OPEB obligation are similar to those in pension calculations. These include salary progression, demographic assumptions and, to a certain extent, discount rates and assumed rates of return on plan assets.

FAS 106 notes that all OPEB assumptions must be consistent to the extent that each reflects expectations about the same future economic conditions, such as future rates of inflation that might affect assumptions for health care cost trend rates, salary progression, and discount rates.

Salary Progression

An OPEB plan may be pay-related, requiring an assumption as to future salary increases. For example, an OPEB life insurance plan may define the amount of death benefit to be received based on the employee's average or final level of annual compensation. Although less common, an OPEB health care plan may define the retiree's deductible or contribution based on similar criteria. For pay-related plans, the calculation of the OPEB obligation would reflect future expected compensation levels, including changes attributable to inflation, productivity, seniority, promotion, and other factors.

Demographic Assumptions

In calculating expected benefits to be provided under a postretirement plan, actuarial factors similar to those used for pension calculations are applied so that future costs reflect estimates of turnover, retirement age, mortality, disability, marital and dependency status, and so forth. Due to differences in the nature of the benefits promised under an OPEB plan, measurement of the related obligation may be much more sensitive to changes in demographic assumptions than the measurement for pension purposes. The assumptions used, however, should be consistent with those reflected in pension calculations for the same participant group.

Turnover

Turnover represents the rate at which employees participating in the plan are expected to leave before becoming eligible for benefits. This assumption will have a significant impact on the OPEB measurement in plans specifying that employees who terminate before the date they are eligible for benefits lose all OPEB benefits earned to date. Because pension plans provide for vesting of benefits over relatively short periods of service, the turnover assumption for pension purposes is generally less sensitive than it is for OPEB purposes.

Retirement Age

The assumption of retirement age can be more critical to the measurement of an OPEB obligation than to a pension obligation. Pension plans often provide for a reduced benefit if early retirement is elected to reflect the longer period over which the retiree is expected to receive a defined benefit. OPEB plans often do not have a similar provision. In addition, prior to age 65, there will be no Medicare reimbursement, resulting in a substantially higher annual per capita cost.

Mortality

The life expectancy assumption also may be more critical to the OPEB measurement than to the pension measurement as per capita health care costs typically increase with age. Pension benefits are typically level periodic payments.

Disability

Many employers provide lifetime health care coverage to employees who retire due to disability. For such plans, rates of disability and recovery are required to project benefit payouts. It may also be necessary to use per capita claims costs specific to disabled retirees if they are greater than for other retirees.

Marital and Dependency Status

In addition to providing benefits to retirees, many OPEB plans provide health care benefits to retirees' spouses and dependents, often with no reduction in benefit levels. For these plans, spousal and dependent coverage can significantly increase the OPEB obligation otherwise payable for retiree only coverage. In contrast, although pension plans may also provide for spousal benefits, they generally do so through a surviving spouse option, which typically provides reduced benefits to take into account the additional payments expected to be made to the spouse subsequent to the retiree's death.

FAS 106 requires that an actuarial assumption be made about employees' expected marital status and number of dependents during retirement. However, in many situations, it is unlikely that the effect of assumed future changes in marital and dependency status will produce a significant change in the aggregate OPEB obligation. While assumptions as to future marital and dependency status may not have a significant impact, the accumulation of demographic data for current spouses and dependents will still be required for plans providing spousal and dependent coverage. Where this data is not available or is incomplete, actuarial estimates will need to be made.

Discount Rates

The use of assumed discount rates is necessary in calculating the OPEB obligation to reflect the time value of money. The concept and its application are the same as those prescribed in FAS 87 for pensions. A discount rate is applied to each future year's expected benefit payment to determine the present value of those payments. The discount rate is also used to calculate annual service and interest costs.

Conceptually, discount rates are intended to reflect the interest rates inherent in the price at which the OPEB obligation could be settled currently with a third party. Settlement of the OPEB health care obligation, however, is likely to be rare, as few insurers are willing to take on the risk of projecting an open-ended promise of medical coverage. Therefore, FAS 106 provides that employers look to the rates of return on high-quality, fixed-income investments with cash flows matching the timing and amount of expected benefit payments. Other discount rates may be relevant for certain other OPEB benefits. For example, discount rates for death benefits may be determinable from the rates inherent in the amount at which the death benefits could be settled through the purchase of nonparticipating life insurance contracts.

Because the discount rate assumption is based on a notion of current settlement, the FASB concluded that use of an employer's incremental borrowing rate, its cost of capital, or the expected rate of return on investments intended to be used to fund the benefits would be inappropriate, as they are enterprise-specific rates that are irrelevant to the cost at which the obligation could be discharged.

In theory, applying discount rates to future benefit payments should result in a present value obligation equal to the current market value of a portfolio of high-quality zero coupon bonds with maturity dates and amounts matching the expected future benefit payments. If other than zero coupon bonds are used in establishing discount rates, for example, double A corporate bond rates with semi-annual interest payments, the discount rate will need to incorporate expected reinvestment rates available in the future on the interest income earned. In addition, if investments are used whose maturities do not extend far enough in the future to match the timing of future benefit payments, those rates will need to be extrapolated from the existing current yield curve at the measurement date. In practice, it is expected that a weighted-average rate, based upon discount rates applicable to the varying periods until the benefits are due, would be used to discount the obligation and calculate periodic service and interest cost.

The FASB concluded that, conceptually, the basis for determining the assumed discount rates for measuring the expected postretirement benefit obligation (EPBO) and the service cost component should be the same as the basis for determining the assumed discount rates for pension measurements (see ARM 4270.3513). The weighted average of the assumed discount rates that is to be disclosed for OPEB may be different from pensions, however, due to the effect of the differences in the assumed timing of cash outflows of each plan.

The assumed discount rates are based on a concept of current settlement and therefore should be reevaluated at each measurement date (including remeasurements required in connection with accounting for plan amendments and curtailments) to determine whether they continue to reflect the best estimates of then current rates. (See FAS 106, par. 31.) The SEC staff expects registrants to develop discount rates based on the current long-term interest rate environment by looking to fixed-income debt securities that receive one of the two highest ratings given by a recognized rating agency (e.g., Aa or higher by Moody's Investors Service, Inc.). (See ARM 4270.3513 for additional discussion of the SEC staff's views on the selection of discount rates; the staff position applies both to pension and OPEB calculations.)

The service cost component of OPEB cost will be volatile as a result of using current discount rates because the changes will immediately affect the EPBO, which is the basis for determining the service cost component. The FASB views this volatility as an appropriate reflection of the current cost of services (i.e., the cost of services purchased in the current period should reflect current period prices). The accumulated benefit obligation (APBO) will also be immediately affected by discount rate changes. However, such changes are classified as actuarial gains or losses, which may be deferred and amortized under the OPEB accounting model, as further discussed at ARM 4380.46. Changes in the discount rate also affect the interest cost component of OPEB cost, although the effect of an increase (or decrease) in the rate will be offset to some degree by the concurrent effect of a decrease (or increase) in the APBO to which the rate is applied.

Refer to ARM 4270.3513 for a discussion of changes in the methodology used to determine discount rates the related guidance with respect to considering consultation with the Accounting Consulting Services Group.

.315 Capped plans

An enterprise is required to measure its share of costs for in-kind health care services by projecting future costs. However, an employer's plan may have a "cap," or limitation, on the dollar amount of health care coverage it promises to pay. For these plans, an employer would measure its obligation for all years in which the limitation is expected to be operative by estimating the future dollar amount of the annual cap. Only in those years in which the cap is not expected to be reached would the employer's obligation need to be calculated by making projections of future per capita health care costs. The cap may be defined in the aggregate for the retiree group, for example, the employer agrees to bear annual costs equal to a specified dollar amount multiplied by the number of plan participants in each future year. Alternatively, the cap may be defined on an individual participant basis. In these situations, if per capita claims cost estimates indicate that the cap will not be reached in certain years for at least some participants, projections of future health care coverage (rather than only the dollar-defined cap) would be required for those years.

Under these plans, the dollar-denominated cap can be fixed, increased automatically (indexed), or redetermined on an ad hoc basis. Therefore, the substantive plan approach may require an employer to anticipate increases in the dollar-denominated amount or ignore the caps for purposes of calculating obligation and expense amounts if:

- The employer communicates its intent to raise the dollar-denominated amount (i.e., the cap) in the future (e.g., to keep pace with inflation), or

- The actual increases in the dollar-denominated amount reflect a consistent past practice.

FAS 106, par. 26 discusses the need to anticipate future improvements in postretirement benefits defined in terms of monetary amounts when there is a past practice of regular increases in such benefits (e.g., retiree life insurance). However, paragraph 26 does not apply to a retiree health plan with dollar-denominated caps.

Since the FASB has not issued any specific guidance regarding the accounting for dollar-denominated plans, extensive judgment will be necessary to determine what constitutes a consistent past practice of increases. We take the view that at least two increases are needed as evidence to change the substantive plan.

If the dollar-denominated caps are based on collective bargaining, there is a general presumption under FAS 106, par. 25, fn 10 that the caps should be included in the measurement (i.e., an increase in the caps included in the written plan should not be anticipated), even after a past practice of increases is established because employers usually do not have the unilateral right to determine the magnitude of increases to a collectively bargained plan where each change in the plan must be bargained. Accordingly, if the plan is subject to union negotiation, employers should not anticipate future increases to the dollar-denominated caps. However, sometimes it will be difficult to assess whether the caps in the retiree plan are subject to actual bargaining, making these provisions in FAS 106 very difficult to apply in practice. For example, if the employer intends to increase the cap for the effects of general inflation without requiring any quid pro quo reductions in benefits, compensation, or other trade-offs, it would be appropriate to assume related increases in the caps.

In some companies, the nonbargained employee group receives the same retiree health benefits as the collectively bargained employee group, and changes to the bargained plan have been historically made at the same time to the nonbargained plan. In that case, assuming the employer intends to continue keeping benefits the same for bargained and nonbargained retirees, employers may take the position that the substantive plan for both plans should be based on the criteria in FAS 106 for collectively bargained plans. This means that the presumption in FAS 106, par. 25, fn 10 that the written plan is the basis for the accounting applies to both the bargained and nonbargained plans.

.4 MEASURING AND REPORTING OPEB COST

FAS 106 adopts the following fundamental concepts for recognizing net periodic OPEB cost, which are consistent with those of FAS 87 for pension accounting:

Reporting net cost. The recognized consequences of events and transactions that affect an OPEB plan are reported as a single amount in the employer's financial statements. That net cost comprises at least three types of events or transactions that might otherwise be reported separately. These include compensation, interest cost, and investment return elements.

Offsetting. Plan assets restricted for only the payment of OPEB benefits are offset against the recorded OPEB obligation, and the return on those assets offsets OPEB cost for the period. That offsetting is reflected even though the obligation has not been settled, the investment of the plan assets may be largely controlled by the employer, and substantial risks and rewards associated with both the obligation and the plan assets are borne by the employer.

Delayed recognition. Certain changes in the obligation and plan assets resulting from actuarial gains and losses need not be recognized in the financial statements immediately, and changes in the obligation resulting from a plan amendment or initiation are required to be deferred. Those changes are generally amortized over future years. Unrecognized amounts are disclosed in the notes to the financial statements.

Cost recognition separate from funding decision. Cash flows related to the plan, such as prefunding of an OPEB obligation, payment of benefits, and asset reversions, are financing transactions. Such outflows and inflows decrease or increase the net OPEB obligation or asset recorded and do not represent OPEB cost. Because cost recognition and funding decisions are distinct, two separate rate assumptions are used to calculate OPEB cost: the discount rate and the return on plan assets.

Net periodic OPEB cost recognition. The amount to be recognized in an employer's financial statements as the cost of a postretirement benefit plan (the net periodic OPEB cost) comprises:

- Service cost
- Interest cost
- Expected return on plan assets, if any
- Amortization of prior service cost (or negative prior service cost)
- Gain or loss recognition
- Amortization of transition obligation (asset), if applicable

The aggregation of each of these elements as OPEB expense is required by FAS 106 and no basis exists to separately classify any of the components, such as interest.

The measurement of the components of net periodic OPEB cost for the year is based on a beginning-of-the-year actuarial valuation using beginning-of-the-year assumptions. Prior to completing the valuation, would record net periodic costs in one or more quarters using an estimate that is based on the disclosed year-end obligations (which are generally based on year-end discount rates and asset values), and a roll-forward of the prior year census data. The estimate is then trued-up in the quarter in which the current year's actuarial valuation is completed to reflect the results of the current valuation. Events that occur subsequent to the beginning-of-the-year measurement date should not, however, be considered in the valuation. Refer to ARM 4270.352.

If a plan settlement, curtailment, or amendment occurs during the year, and the effect on OPEB cost is significant, a new measurement should be performed. The new measurement should include measurement of any plan assets and the obligation and should be used to determine net periodic OPEB cost prospectively from the date of the event.

Employers with two or more plans. In measuring net periodic OPEB cost and the obligations and assets, each funded OPEB plan should be measured separately. However, the data from all unfunded OPEB welfare plans may be aggregated in situations where the plans are similar. Specifically, if the unfunded plans provide different benefits to the same group of employees or the same benefits to different groups of employees, the plans can be aggregated in applying FAS 106. Measurement of other unfunded OPEB welfare benefits may be performed on an aggregate basis in similar situations. FASB Q&A.106, question 42 states if the conditions for aggregation are no longer met, the plans should be accounted for separately. However, if the change in aggregation is elective, the employer would have to demonstrate preferability and the effects of the change would be accounted for in accordance with APB 20, "Accounting Changes."

.41 Attribution of Cost to Reporting Periods

The expected postretirement benefit obligation (EPBO) is the actuarial present value at a particular date of the total postretirement benefits expected to be paid to or on behalf of employees and their dependents and beneficiaries. The EPBO is the basis for calculating the compensation element of net periodic OPEB cost, the service cost component, and the accumulated postretirement benefit obligation (APBO). The APBO is the portion of the EPBO earned to date and not yet paid (i.e., the aggregation of the EPBO attributed to plan participants' prior service periods, together with interest cost, less benefits paid).

FAS 106, par. 43 prescribes the following method for attributing the EPBO to individual service periods for purposes of calculating periodic service cost and the APBO:

> An equal amount of the expected postretirement benefit obligation for an employee generally shall be attributed to each year of service in the attribution period (a benefit/years of service approach). However, some plans may have benefit formulas that attribute a disproportionate share of the expected postretirement benefit obligation to employees' early years of service. For that type of plan, the expected postretirement benefit obligation shall be attributed in accordance with the plan's benefit formula.

.411 Beginning of the attribution period

The beginning of the attribution period is generally the date of hire. An exception exists if the plan's benefit formula grants credit only for service from a later date and the entire employee service period for which benefits are earned (i.e., the credited service period) is not nominal in relation to employees' total years of service prior to their full eligibility dates. For example, if a plan provides benefit coverage to employees who render at least 20 years of service after age 35, the EPBO is attributed to the participant's first 20 years of service after age 35 or after date of hire if later than age 35. If eligibility was based on credit for 10 years of service after age 45, we believe a 10-year service period is not nominal and would be the appropriate attribution period under FAS 106 in this example (i.e., the EPBO would be attributed to the first 10 years of service after age 45). Employers should be aware that while this type of credited service period may reduce the obligation and expense initially, if the work force is relatively young, the shorter attribution period (in this case 10 years) increases service cost and could even result in higher total expense. Giving credit only after age 45 eliminates the APBO for employees under age 45 but may increase expense significantly in later years. However, if other plan terms affecting benefits are based on service from an earlier date (e.g., retiree contributions that vary with service based on service from date of hire), the credited service period should be viewed as inoperative for FAS 106 accounting (e.g., attribution should begin at date of hire).

Determination of the beginning of the attribution period requires careful analysis where the service period is undefined. FASB Q&A.106, question 14 cites the following eligibility requirements: "15 years of service after both (a) reaching age 50 and (b) rendering 10 years of service." The requirements grant credit for 10 years of service before age 50, but those years of service are not defined. Therefore, the attribution period begins at date of hire. FASB Q&A.106, question 19 and 20 provide further examples of situations where complex eligibility criteria result in the attribution period beginning at date of hire.

.412 Full eligibility date

The end of the attribution period is the full eligibility date. At that date, an employee's APBO and EPBO are equal. The full eligibility date is the date on which an employee has rendered all the service necessary to receive all the benefits expected to be received by that employee (including any beneficiaries and dependents expected to receive benefits). This date could precede the employee's expected retirement date, depending on the terms of the plan.

Note that while the full eligibility date is used for attribution, the expected retirement date is used for measurement of the expected benefits. To illustrate, an employee's EPBO at January 1 of $18,000 was calculated as the actuarial present value of benefits to be provided beginning at age 65, the expected retirement date. However, because the employee will be fully eligible for OPEB at age 55, this is the age through which the EPBO would be attributed. While there would be no additional service cost beyond age 55, interest, amortization of gains or losses or other components of OPEB cost would continue.

In determining the full eligibility date, plan terms that provide incremental benefits expected to be received by an employee for additional years of service extend the attribution period, unless those incremental benefits are trivial. Salary progression and benefit indexation formulas are examples of plan provisions providing incremental benefits. To illustrate, assume an employee is eligible for postretirement life insurance benefits after rendering 10 years of service and attaining age 55, but the amount of insurance benefits earned under the plan are indexed until retirement (e.g., based on final salary at retirement). Even though an employee has met the age and service requirements, the full eligibility date has not yet been reached because the employee earns additional benefits each year for salary increases until retirement. (See example in FASB Q&A.106, question 15-17.)

As another example of an incremental benefit provided for additional years of service, a plan may provide single coverage to employees who work for an enterprise for 10 years and attain age 55 while in service and dependent coverage for employees who work 20 years and attain age 65 while in service. For an employee expected to meet the necessary age and service requirements and also expected to have dependents during retirement (even though none may exist today), the full eligibility date is the date that employee has rendered 20 years of service and attained age 65.

Still another example of an incremental benefit is a graded benefit formula. An employee hired at age 32 and expected to retire at age 60 (with 28 years of service) would be fully eligible for the expected level of benefits (50% of eligible costs) at age 52, that is, when 20 years of service have been rendered. Thus the attribution period is 20 years, even though the expected service period is 28 years. If that same employee were expected to retire at age 65, the expected level of benefits (80% of eligible costs) would be reached at age 62, that is, when 30 years of service have been rendered. The attribution period would be 30 years, even though the expected service period is 33 years.

.413 Ratable allocation

FAS 106 generally prescribes that an equal amount of the expected postretirement benefit obligation (EPBO) be attributed to each year of service in the attribution period, regardless of the existence of a benefit formula that specifies the benefits earned for individual periods of service. An exception exists in the rare situation where the benefit formula attributes a disproportionate share of the EPBO to early years of service. In that situation, the benefit formula is followed. This methodology is different from that required by FAS 87, under which benefits are attributed ratably only in the absence of a plan formula. (For further guidance, see FASB Q&A.106, question 18.) The FASB concluded that ratable allocation would be less complex, especially in situations where the benefit formula grants differing levels of benefits depending on years of service and where it is supplemented by other eligibility criteria. Ratable allocation avoids the need for interpreting plan terms to determine specific benefits provided in exchange for each year of service.

.42 Service Cost

The service cost component of net periodic OPEB cost represents the actuarial present value of the future benefits attributed to service during that period, calculated using the benefit/years-of-service (i.e., projected unit credit) method. Calculation of the future benefits, and therefore the service cost, is made using the substantive plan provisions.

.43 Interest Cost

The accumulated postretirement benefit obligation (APBO) is measured at present value using discount rates representing the rates of return on high-quality fixed income investments. The interest cost component is the increase in the APBO due solely to the passage of time. Stated another way, interest cost represents accretion of interest on the beginning-of-the-year APBO, adjusted for benefit payments during the period.

.44 Return on Plan Assets

Many postretirement benefit plans are not funded. For those that are, if investments meet the definition of assets, the expected return on those assets is a component of net periodic OPEB cost.

The expected return on plan assets is recognized currently as a component of net periodic OPEB cost. Any difference between the expected and actual return on assets is an unrecognized net gain or loss, which may be recognized on a delayed basis (see ARM 4380.46). For disclosure purposes, the actual return on plan assets is presented as a component of OPEB cost; the difference from the expected return is included in the "other" component of the OPEB cost disclosure.

The expected return on plan assets is the product of the expected long-term rate of return and the market-related value of the plan assets. The expected long-term rate of return should reflect the average rate of earnings expected on only existing plan assets, plus expected contributions for the current period. In estimating that rate, the returns earned by the plan assets currently invested and the rates of return expected to be available for reinvestment should be considered. If the return on plan assets is taxable to the plan trust or other holder of those assets, the expected long-term rate of return should be reduced to reflect the related income taxes expected to be paid under existing law. Calculation of the expected return on plan assets take into account changes in the level of plan assets occurring throughout the year, for example, due to contributions and benefit payments.

The actual return on plan assets is derived by comparing the beginning and end of the period plan assets, at fair value, adjusted for contributions and benefit payments during the year. If the return on plan assets were taxable to the trust or other holder, the actual return on plan assets would reflect the tax expense or benefit for the period.

Calculations required to determine the return on plan assets for FAS 106 plans are similar to those for FAS 87 plans. See ARM 4270.3523 for further discussion.

.45 Amortization of Prior Service Cost

.451 Definition of prior service cost

Plan amendments are defined by FAS 106 to include plan initiations. Plan amendments may increase or reduce benefits, and may attribute the change to service rendered in prior periods (retroactive amendments) future periods (prospective amendments). Under FAS 106, plan amendments, even prospective generally result in prior service cost. The prior service cost is measured as the increase or decrease in the APBO at the date of the amendment. Assuming these will be communicated to plan participants in a reasonable period of time, this date is generally the date that the amendment is approved by the highest level of management necessary to make the change for a nonbargained plan, or the date of the bargaining agreement for a bargained plan. The treatment of amounts related to prospective amendments as prior service cost differs from the FAS 87 treatment, which requires that changes in benefits related to future be accounted for as service cost in future periods. While inconsistent with FAS 87, the concept is consistent with the FAS 106 requirement to generally ignore the benefit formula and instead attribute costs ratably. When a plan is initiated and benefits are granted solely for service after plan initiation or a future date, there is no prior service cost because the credited service period begins at the date of the plan initiation or the future date.

.452 Amortization period

Although a plan amendment immediately affects the calculation of the APBO, FAS 106 requires that prior service cost be deferred and amortized over the period benefited, generally service to the full eligibility date. Delayed recognition reflects the assumption that plan benefit improvements are made with the expectation the employer will realize economic benefits in future periods. An accounting policy of immediately recognizing the cost of all plan amendments is not permitted. Note that amortization of prior service cost should begin at the date of the plan amendment (i.e., the approval date not the effective date of the amendment) even if it occurs during a fiscal year, provided that it is communicated to plan participants at that time or within a reasonable period of time thereafter. (Refer to FASB Q&A.106, question 23.) The prior service cost from each plan amendment should be amortized separately.

.453 Exceptions to the typical amortization period

If all or substantially all plan participants are fully eligible for benefits, amortization is based upon the remaining life expectancy of the fully eligible participants (including retirees) rather than the remaining years of service of active plan participants. FASB Q&A.87 deals with the question of whether there is a threshold for "all or substantially all" by indicating that judgment is required based on the facts and circumstances of the particular plan. However, we would generally expect that at least 90% of participants would be fully eligible in order for employers to use this alternative amortization period.

Another exception to amortization through the full eligibility date occurs in situations where, similar to pensions, "a history of regular plan amendments and other evidence may indicate that the period during which the employer expects to realize economic benefits from an amendment that grants increased benefits is shorter than the remaining years of service to full eligibility for benefits of the active plan participants" (FAS 106, par. 54). In those situations, the amortization of prior service cost should reflect the expected periods to be benefited (a more rapid rate of amortization). Note that this provision applies only to benefit increases.

Temporary deviations from the substantive plan are not considered a plan amendment resulting in prior service cost. Their effects are required to be immediately recognized as a gain or loss. (Refer to ARM 4380.464.)

.454 Amortization method

FAS 106 requires that prior service cost generally be amortized "by assigning an equal amount to each remaining year of service to the full eligibility date of each plan participant active at the date of the amendment who was not yet fully eligible for benefits at that date" (FAS 106, par. 52). Under this method, each remaining year of service prior to the full eligible date of each active plan participant not yet fully eligible for benefits is assigned an equal share of the prior service cost. The portion of the prior service cost to be recognized in each of those future years is therefore weighted based on the number of those plan participants expected to render service in each of those future years. Plan participants are defined as employees or former employees who are expected to receive benefits under the plan. Illustration 4A in FAS 106, par. 451-453, Appendix C illustrates an application of this principle.

.455 Alternative amortization methods

As a means of reducing the complexity and detail of the calculation, FAS 106 permits the use of alternative amortization methods that more rapidly recognize prior service cost, provided the alternative method is consistently applied. For example, an employer may elect to use straight-line amortization over the average remaining years of service to full eligibility for active plan participants, as described in Illustration 4B in FAS 106, par. 454, Appendix C. Because the average remaining service period is less than the period used in the minimum amortization approach (which is based on the weighted remaining years of service method), this results in more rapid recognition.

.456 Negative plan amendments

In situations where a plan amendment reduces rather than increases benefits (and the APBO), the reduction would first be used to reduce any unrecognized prior service cost from previous plan benefit improvements and then to reduce any remaining transition obligation. The excess, if any, would be amortized to net periodic OPEB cost on the same basis as prior service cost arising from benefit increases. Negative plan amendments are likely to be more common for OPEB plans than pensions plans, and could include increases in required participant contributions or deductibles not already part of the substantive plan, the institution of a dollar-defined cap on the employer's share of costs, and reductions in benefit coverage.

When there have been previous plan amendments that increased benefits, followed by a negative plan amendment, special considerations may apply. When the aggregate unrecognized prior service cost related to those previous amendments exceeds the decrease in benefits related to the negative plan amendment, the question arises as to what ordering method (e.g., LIFO, FIFO, or pro rata) should be used to reduce unrecognized prior service cost related to the previous benefit improvements. Because prior service cost from plan amendments is amortized over the estimated remaining years of future service to the full eligibility date of each plan participant active at the date of each amendment, at any point in time each plan amendment will be subject to amortization over different periods and in differing proportions. Thus, the order of reducing the unrecognized prior service cost will directly affect the amount of prior service cost to be recognized in each future period. Unless the plan amendment reducing the OPEB obligation is specifically related to a prior amendment, we believe that any systematic method, applied consistently, would be acceptable. This guidance is consistent with the FASB staff's position for pensions, as described in the answer to FASB Q&A.87, question 21. (See discussion at ARM 4380.114.)

FASB Q&A.106, question 24, 25 and 30 discuss the differences between a negative plan amendment and a curtailment. In particular, Example 3 in the answer to FASB Q&A.106, question 30 helps distinguish the limited situation in which curtailment accounting (as contrasted to negative plan amendment accounting) is appropriate where there has not been a termination of employee services earlier than expected. That illustrates the accounting for a negative plan amendment that results in a curtailment gain and, along with Examples 4 and 5 in the answer to FASB Q&A.106, question 30, illustrates that when a negative plan amendment results in a curtailment, the accounting should first reflect the effects of the negative plan amendment and then the effects of the curtailment. Unlike situations in which both a settlement and a curtailment occur, and an employer may choose the order of recording curtailment and settlement events (FASB Q&A.88, question 41), there is no such choice available to employers when a negative plan amendment results in a curtailment.

FASB Q&A.106 also indicates that when a negative plan amendment also gives rise to a curtailment (e.g., the adoption of a credited service period of 10 years after age 45), the reduction in the APBO from the negative plan amendment is not accelerated by the curtailment. The curtailment may only accelerate previous unrecognized prior service cost or transition obligations.

.46 Recognition of Gains and Losses

Gains and losses represent changes in the APBO or the value of plan assets resulting either from actual experience different from that expected or from changes in actuarial assumptions. FAS 106 does not make a distinction between gains and losses arising from investment activities and those arising from other actuarial assumptions.

As with pension calculations, some portion of the gains and losses may reflect real changes in economic values of plan assets or the obligation, while the remainder may result from the inability to accurately predict future benefits and asset returns. This latter cause is likely to be especially true for postretirement health care benefits. The FASB noted that "recognizing the effects of revisions in estimates in full in the period in which they occur may produce financial statements that portray more volatility than is inherent in the employer's obligation" (FAS 106, par. 293, Appendix A). Therefore, as in pension accounting, gains and losses are not required to be recognized immediately but may be deferred in the period when they occur and amortized prospectively.

FAS 106, par. 59-60 allows an employer to amortize gains and losses using any method as long as it is at least equal to the stipulated minimum (see ARM 4380.463) and the method is applied consistently from period to period. As noted in FASB Q&A.106, question 32, it is not appropriate for an employer to elect annually a new method of amortization of unrecognized gains and losses. Any change in the method selected should be accounted for in accordance with APB 20. APB 20 requires the justification for the preferability of the change in accounting.

.461 Immediate recognition allowable

FAS 106 does not, however, preclude immediate recognition. If an employer adopts a consistent policy of immediately recognizing gains and losses: (1) the amount of any net gain in excess of a net loss previously recognized in income would first offset any unamortized transition obligation; and (2) the amount of any net loss in excess of a net gain previously recognized in income would first offset any unamortized transition asset (for most companies, the existence of a transition asset generally is unlikely). This constraint was added because the FASB did not want gains (losses) to be recognized before the unfunded (overfunded) APBO was recognized. If immediate recognition is adopted, this policy should be disclosed. Adoption of a policy of immediate recognition of gains and losses is likely to produce some, and perhaps significant, volatility in periodic OPEB cost, given the degree of judgment involved and the difficulty in estimating future health care cost trends.

.462 The "corridor" approach for deferred recognition

The requirements for amortizing gains and losses are consistent with those prescribed by FAS 87. Deferred gains and losses are amortized as a component of net periodic OPEB cost if they exceed a "corridor." The corridor is defined as the greater of 10% of the APBO or 10% of the market-related value of plan assets. The corridor approach is intended to reduce OPEB cost volatility by providing a reasonable opportunity for gains and losses to offset over time without affecting OPEB cost. Note that while amortization and the corridor approach reduce the volatility that otherwise would result from changes in the APBO or plan assets, some, and possibly significant, volatility in OPEB cost will still result due to the immediate effect of such changes on the EPBO, which is used to determine subsequent periods' service cost.

.463 Amortization methods

If amortization is required, the minimum amortization amount is the excess (beyond the corridor) divided by average remaining service period of active plan participants. As a result, aggregate net gains or net losses falling within the corridor are not a component of net periodic OPEB cost. Plan asset gains and losses not yet reflected in the market-related value of plan assets are also not required to be considered for amortization ARM 4380.53).

If all or substantially all participants are inactive, the average remaining life expectancy of plan participants is used instead of the average remaining service period of active participants. Inactive participants would individuals covered by a terminated plan, while participants who are inactive due to a temporary suspension of the plan would not be considered inactive for amortization purposes.

In addition, FAS 106 provides that any systematic method of amortization may be used in lieu of the specified method, provided that: (1) if in any period the minimum amortization is greater, the minimum is used in that period; (2) the method is applied consistently; (3) the method is applied similarly for both gains and losses; (4) the method is disclosed.

.464 Deviations from the substantive plan

FAS 106 includes a provision for situations not applicable to pension plans under which an employer temporarily deviates from the provisions of the substantive plan to increase or decrease benefits related to past or current periods. To illustrate, some plans include terms (either written or substantive) that provide that shortfalls resulting from benefit payments in excess of the employer's share of incurred claims cost and participant contributions for a year are to be recovered through the subsequent year's participant contributions (i.e., a retrospective adjustment). If an employer forgives that retrospective charge on a one-time basis, that decision is required to be recognized as a current period loss rather than deferred and amortized. The theory behind this requirement for immediate recognition is that the change results from a temporary change in intent rather than a change in estimate or permanent plan change. If the change were other than temporary, for example, if facts and circumstances indicated that the employer had in substance made a decision to continue to bear the shortfall in future years as well, the effect of that change on the APBO would be calculated and accounted for as a plan amendment.

.465 Amortization of transition obligation (asset)

For employers that elected the delayed recognition method of adoption of FAS 106, the transition amount is amortized on a straight-line basis as a component of net periodic OPEB cost. The amortization period is generally the average remaining service period of active plan participants, but FAS 106 allowed the amortization to take place over 20 years if the average remaining service period at transition was less than 20 years. Amortization of the transition amount is adjusted prospectively to recognize the effects of certain events. These include: (1) the constraint on the delayed recognition of the transition obligation when cumulative benefit payments exceed cumulative OPEB cost; (2) a negative plan amendment; (3) the constraint on immediate recognition of a net gain or loss when a transition obligation or asset exists; (4) settlement accounting; and (5) curtailment accounting. Other than these events, an employer may not elect to accelerate the remaining unamortized transition obligation (asset).

.47 Employers' Disclosure About Other Postretirement Benefits

THE FASB HAS A LIMITED-SCOPE PROJECT ON ITS AGENDA ENTITLED, "DISCLOSURES ABOUT PENSION PLANS." IN THIS PROJECT, THE FASB IS CONSIDERING CERTAIN DISCLOSURE IMPROVEMENTS RELATED TO PENSION COSTS, PLAN ASSETS, OBLIGATIONS, AND FUNDING REQUIREMENTS. IN ADDITION, THE FASB IS CONSIDERING SIMILAR DISCLOSURE IMPROVEMENTS FOR OTHER POSTRETIREMENT BENEFITS. THE FASB PLANS TO ISSUE AN EXPOSURE DRAFT ON THIS PROJECT IN THE THIRD QUARTER OF 2003.

For other postretirment benefit disclosures that are required as well as some illustrations of footnote examples, refer to FAS 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits (an amendment of FASB Statements No. 87, 88, and 106)." FAS 106, par. 74, 77-78, 82, 106 and 107 have been replaced by applicable paragraphs within FAS 132.

Presentation requirements for a public company. The public company examples in FAS 132 present two-year comparative information for all benefit (pension and OPEB) disclosures. However, there is an SEC requirement to present two years of footnote information related to balance sheet disclosures and three years of footnote information for disclosures related to the income statement and statement of cash flows. In order to comply with the SEC requirement, registrants should present three years of information in the table that presents the components of net periodic benefit cost along with three years of the weighted-average assumptions because of the linkage to the income statement. As shown in the FAS 132 examples, only two years of information is required for the reconciliations of the change in benefit obligations and plan assets along with the funded status reconciliation.

We have confirmed with the FASB staff that the requirements of SEC Regulation S-X must be followed by SEC registrants, which means two years of footnote information for balance sheet disclosures and three years of footnote information for income statement and statement of cash flow disclosures should be presented. Thus, for SEC registrants the SEC's disclosure requirements override the example presented in FAS 132. The reason for the two-year presentation in FAS 132 is historical precedent; FASB Statements typically include only two years and do not reflect the SEC required presentations.

A mistake in Illustration 2 of Appendix B in FAS 132, par. 63 has been corrected by FAS 135. Refer to ARM 4270.8 for details about the technical corrections in FAS 135 affecting FAS 106.

A question has arisen whether the existence of debt obligations traded in the over-the-counter market and quoted only locally or regionally makes an entity public. For example, an entity (e.g., a privately capitalized partnership or corporation, a not-for-profit organization, or a higher-education institution) may issue debt obligations that are not listed on a trading exchange; however, individual investors may purchase an interest in the obligations. In some circumstances, the obligations may include credit enhancement by a governmental agency (e.g., New York State Dormitory Authority); however, the issuing entity remains the primary obligor.

An entity whose debt obligations are available to and traded by investors, regardless of how limited those obligations are in scope, should be considered a public entity for purposes of applying FAS 132. In FAS 132, the FASB reduced disclosure requirements for nonpublic entities because nonpublic financial statement "users observed that they did not require the same level of precision in assessing benefit costs and net income" (FAS 132, par. 57). However, the information that would be disclosed by public entities under FAS 132 would probably be of particular interest to an investor who was considering (or an analyst who was recommending) participation in debt obligations of an entity that is otherwise considered to be nonpublic.

It should be noted that the definition of a nonpublic entity in FAS 132 is not identical to the definition in FAS 123, "Accounting for Stock-Based Compensation." The FAS 132 definition includes entities whose "debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally." FAS 123 does not consider companies with only debt securities trading in a public market to be public companies.

.5 MEASUREMENT OF PLAN ASSETS

.51 Definition of "Plan Assets"

Unlike pension plans, many employers do not prefund postretirement benefits. For employers that do, FAS 106 prescribes the accounting.

Assets segregated and restricted (usually in a trust) for paying only postretirement benefits meet FAS 106's definition of "plan assets." Plan assets include contributions by employers and by participants in a contributory plan; and amounts earned on the invested funds, less benefits, taxes and other expenses incurred. FASB Q&A.106, question 38 notes that employer securities held in an OPEB trust are considered plan assets as long as the securities are currently transferable (i.e., already registered). A nontransferable security that is convertible at any time into a transferable security is not considered a plan asset because it is not "currently" transferable.

Plan assets generally cannot be withdrawn by an employer except in situations where they exceed plan obligations and the employer has taken certain steps to satisfy those obligations. The issue of whether assets must be segregated in a manner that makes them "bankruptcy-proof" to qualify as plan assets was addressed in EITF 93-3, "Plan Assets under FASB Statement No. 106." The EITF reached consensuses that (1) it is not necessary to determine that a trust is bankruptcy proof for the assets of the trust to qualify as plan assets under FAS 106, and (2) assets held in a trust that explicitly provides that such assets are available to the general creditors of the employer in the event of the employer's bankruptcy (e.g., rabbi trusts) would not qualify as plan assets under FAS 106.

Investments made with the intention of paying postretirement benefits but that are not segregated in a trust or otherwise effectively restricted to pay only postretirement benefits are not plan assets. For example, a VEBA may exist to pay benefits of both active and retiree health care plans. Unless the VEBA assets are legally segregated only for retiree benefits, those assets would not be considered plan assets, but instead would be accounted for as other employer assets of a similar nature and with similar restrictions (generally accounted for as company assets under FAS 115, "Accounting for Certain Investments in Debt and Equity Securities"). Assets held in the form of a rabbi trust (see ARM 4300.3) and the cash surrender value of corporate-owned insurance (COLI) are also excluded from plan assets, as both are not restricted solely for the payment of OPEB. Rabbi trust assets revert to the sponsoring entity in the event of bankruptcy, and the employer is the owner or beneficiary of a COLI policy.

Depending on the purpose of the measurement, plan assets are measured in one of two ways: fair value or market-related value. Fair value is used for disclosure of the funded status of the plan and in determining the actuarial gain or loss on plan assets. Market-related value is used in computing the expected return on plan assets and the portion of actuarial gain or loss on plan assets subject to amortization.

.52 Fair Value

Fair value is defined as the amount that a plan could reasonably expect to receive for an investment in a current sale between a willing buyer and seller. Fair value is considered to be the most relevant disclosure information for assessing the plan's ability to pay benefits as they become due and the future contributions necessary to provide benefits promised.

Contracts with insurance companies that are not unconditional legal obligations of an insurance company to provide specified benefits to specific individuals may be considered plan assets. The purchase of an unconditional insurance contract would in some cases require settlement accounting (refer to ARM 4380.72 further discussion on insurance contracts affecting settlement accounting). Because insurance contracts typically have no secondary market, fair value would generally be determined through estimation. FAS 106, par. 71 notes that "if a contract has a determinable cash surrender value or conversion value, that is presumed to be its fair value. For some contracts, the best available estimate of fair value may be contract value."

.53 Market-Related Value

Market-related value can be either fair value or a calculated value that recognizes changes in fair value over not more than five years through a systematic and rational amortization method. This delayed recognition concept is consistent with that allowed under FAS 87 for pension plan assets (see ARM 4270.353). The market-related value can be determined using different methods for different classes of assets (e.g., stocks, bonds and real estate), as long as the method for each class is used consistently from year to year. In situations where the employer has several plans with similar investments, an employer would typically use the same asset valuation methods for each class of asset, unless facts and circumstances warrant use of a different method. Illustration 5 of Appendix C in FAS 106, par. 455-471 depicts an approach for calculating the market-related value of plan assets. Any change in market-related value methodology is treated as an accounting change under APB 20. However, the SEC takes the position that switching from fair value to a calculated value solely or primarily to avoid the effect that volatility in the financial markets would have on the employer's reported earnings would not be sufficient to justify such a change. (Refer to ARM 4270.71).

.54 Measurement Date

The "measurement date" used for (1) determining fair value of plan assets and the plan obligation for balance sheet recognition, (2) disclosure purposes, and (3) for determining plan cost in the following year, may be either the date of the financial statements or a date no more than three months prior to that date. For example, plan assets and obligations of a calendar year-end company may be measured as of a date no earlier than September 30. The measurement date must be the same for both plan assets and obligations, and must be used consistently each year. Changes in the measurement date would be subject to APB 20's preferability and cumulative catch-up adjustment requirements. Generally, it may be hard to justify the preferability of changing the measurement date from the financial statement date to an earlier date, unless the use of an earlier measurement date will produce more accurate results (e.g., if more accurate asset and obligation values are available at September 30 than at December 31).

For qualified plans, ERISA requires an annual valuation as of the plan year-end based upon the terms of the plan and employee census data at that date. The actuarial valuation date can differ from the employer's measurement date. As noted in FASB Q&A.87, question 65, the obligation may be measured based upon projections of the census data used in the most recent actuarial valuation, updated for changes prior to the measurement date (e.g., benefits earned, contributions, benefit payments, and significant changes in assumptions and in the work force).

Certain plan information can be prepared prior to the measurement date and projected through that date. For example, the obligation may be measured by rolling forward data based upon a valuation prior to the measurement date. The "roll-forward" would include benefits earned, benefit payments, contributions and changes in the work force. Plan cost for both interim and annual reporting is based upon actuarial assumptions at the beginning of the year (i.e., those used at the previous year-end measurement date), where more recent measurements of the plan obligations and plan assets exist because a significant event occurred requiring remeasurement. For example, a significant plan amendment would require a current measurement to measure the effect of the amendment and account for it prospectively. Similarly, since settlements and curtailments require remeasurements of plan obligations and assets, the revalued amounts, adjusted for the effects of the settlement and/or curtailment, should be used prospectively to measure the plan cost.

FASB Q&A.88, question 28 addresses recognition of a gain or loss from a settlement or curtailment when the measurement date is other than the date of the financial statements. FASB Q&A.88 requires that gains or losses occurring subsequent to the measurement date and prior to the date of the financial statements should generally not be reflected in the fiscal period's results of operations. However, if the gain or loss results from the employer terminating the pension plan and not establishing a successor pension plan, the effect of the settlement and curtailment should be recognized in the current fiscal year.

If the gain or loss is not recognized in the current fiscal year and the employer's financial position or results of operations would have been materially affected had it been recognized, then disclosure of the event, its consequences, and when recognition will occur should be made in the financial statements for the current fiscal year. In other words, companies that have a measurement date preceding its fiscal year-end should disclose significant events that occur after the measurement date but before the fiscal year-end. However, the disclosed plan assets and obligations should not be updated. For example, if a September 30 measurement date is used for December 31 reporting purposes, the effects of a significant plan amendment at October 31, 20X3 should be disclosed in the 20X3 financial statements. However, a remeasurement should take place at October 31, 20X3 so pension cost for 20X4 would be based on one month of the old plan valuation and eleven months of the new plan valuation.

We believe the necessity to disclose the effect of a postmeasurement date event should be evaluated against the respective reportable components of the plan instead of determining significance (materiality) solely in relation to the results of operations.

.6 OTHER CONSIDERATIONS

.61 Defined Contribution Plans Covered by FAS 106

A defined contribution postretirement plan is defined by FAS 106, par. 104 as "a plan that provides postretirement benefits in return for services rendered, provides an individual account for each participant, and has terms that specify how contributions to the individual's account are to be determined rather than the amount of postretirement benefits the individual is to receive."

Some plans contain features of both defined contribution and defined benefit plans. Careful analysis of the plan is required. If, in substance, the plan provides a defined benefit, the accounting and disclosure requirements should be those required for a defined benefit plan. For example, in some plans there may be an unfunded account balance established for each plan participant. Thus, while the form of the plan may look like a defined contribution plan, the substance and employer's commitment may weigh more heavily on the side of a defined benefit plan.

.611 Accounting

FAS 106 does not significantly change generally accepted accounting principles for OPEB benefits offered through a defined contribution plan. Typically, the amount contributed to such a plan is also that period's accounting cost. If, however, a plan provides for contributions for periods after an individual retires or terminates employment based on criteria specific to that employee (e.g., additional amounts are to be contributed for the first 10 years subsequent to retirement), the estimated cost of postretirement contributions should be accrued through the employee's full eligibility date. Disclosure requirements for defined contribution plans are covered in FAS 132, par. 9.

.62 Multiemployer Plans

OPEB plans that two or more unrelated employers contribute to, generally pursuant to collective bargaining agreements, and that have certain other attributes are multiemployer plans. Such plans are sometimes referred to as "joint trust" or "union plans." This is the identical definition that exists for FAS 87 purposes and the accounting required by FAS 106 is similar. A key characteristic of a multiemployer plan is that the plan's obligation to retirees continues even if a former employer discontinues its participation in the plan. See ARM 4270.363 and FASB Q&A.106, question 43 and 44. Under FAS 132, the total contributions to all multiemployer plans may be disclosed (total attributable to pension and other postretirement benefits); the separate OPEB contribution amount need not be separately disclosed.

.63 Multiple-Employer Plans

Similar to FAS 87, FAS 106 describes multiple-employer plans as aggregations of single-employer plans combined to permit participating employers to pool fund assets for investment purposes and reduce plan administration costs. These arrangements may allow employers to have different benefit formulas, with each employer's contribution to the plan based on the benefit formula it selects. Typically, multiple-employer plans do not involve collective bargaining agreements. Under FAS 106, such plans are considered to be single-employer plans, and each employer would account for its respective interest in the pooled assets.

.64 Non-U.S. Plans

Because many foreign countries have some form of nationalized health insurance, employer promises to provide retiree health care coverage may not be as prevalent among non-U.S. entities. In effect, the cost for non-U.S. operations' postretirement health care is often reflected in local taxes or social security contributions.

There may be other situations where non-U.S. arrangements similar in substance to OPEB plans offered in United States exist. Even in countries with nationalized health insurance, the coverage provided by such insurance may be limited. As a result, employers may still have OPEB plans albeit of a more restricted nature. Experience has shown that the liability that results from even restricted coverage plans can be significant. Such plans are required to be accounted for in accordance with the provisions of FAS 106 and the appropriate disclosures made in accordance with FAS 132.

The applicability of FAS 106 to these plans should be determined by the nature of the obligation and the terms and conditions that define the amount of benefit payments, not by the funding mechanism, whether the benefits are payable over more than one period or in lump-sum, or whether the benefits are required by law or custom.

.65 Subsidiaries

In cases where subsidiary employees participate in parent company postretirement benefit plans, our position is that the accounting should be similar to that prescribed by the answer to FASB Q&A.87, question 87. That is, a corporation that has a defined benefit plan that covers employees at its subsidiaries should account for the plan as a single-employer plan in the consolidated financial statements. In the subsidiary financial statements, however, the arrangement should be accounted for as a participation in a multiemployer pension plan.

FASB Q&A.106, question 56 addresses the accounting for the transition obligation for a subsidiary when it has its own separate postretirement plan. The guidance requires that for purposes of consolidated financial statements, the method of recognizing the transition obligation must be the same as the method selected by the parent for other plans in the consolidated group. However, in the separate subsidiary financial statements, a different method may be chosen.

.66 Insurance Contracts

An insurance contract is defined in FAS 106, par. 67 as "a contract in which an insurance company unconditionally undertakes a legal obligation to provide specified benefits to specific individuals in return for a fixed consideration or premium; an insurance contract is irrevocable and involves the transfer of significant risk from the employer (or the plan) to the insurance company." Benefits covered by such insurance contracts are excluded from the APBO and the contract is excluded from plan assets, except for any participation right as described below.

Insurance contracts may be either participating or nonparticipating. Participating arrangements allow the purchaser (the employer or plan) to participate in the investment performance or other experience of the insurer. If the substance of the participating arrangement causes the employer or plan to remain subject to most or all of the risks and rewards of ownership of the OPEB obligation or assets transferred to the insurer, the insurance contract would be considered a plan asset, and the related promise to provide benefits would be included in the APBO. FAS 106 does not provide specific quantitative criteria for determining whether significant risks and rewards of ownership have effectively been transferred. As a general rule, we believe if the cost of the participation right (the difference between the cost of a participating and nonparticipating contract) exceeds 10% of the nonparticipating contract premium, a significant portion of the risks and rewards have not been transferred.

For participating contracts where a significant portion of the risks and rewards of ownership have been transferred, the cost of the participation right (not the entire contract) is established as an asset on the date of purchase and remeasured subsequently at its fair value. Carrying value should be assessed for recoverability on an ongoing basis. Dividends paid on such contracts are accounted for as a return on plan assets.

Some employers enter into agreements whereby benefits earned in the current period are covered by the annual purchase of an insurance annuity contract. The premium cost of those benefits is the service cost component of the net periodic OPEB cost, except as described above for the cost of any participation right (see FASB Q&A.106, question 11 and 12). Annuity contracts may also be purchased to provide for benefits earned for past years' services (i.e., to settle the APBO). Accounting for contracts used to settle an OPEB obligation is discussed in ARM 4380.71.

.67 Income Tax Considerations

For income tax purposes, the OPEB cost deduction is significantly limited. Thus, FAS 106 OPEB cost will generally result in an amount higher than that allowable as a deduction for tax purposes.

Under FAS 109, differences between OPEB obligations or assets recorded for financial reporting purposes (including the effect of transition) and the amounts reflected on the tax-basis balance sheet are temporary differences. Because of the limitations on tax deductibility, the temporary differences would likely result in a potential deferred tax benefit.

Under FAS 109, the recording of deferred tax benefits is subject to a realizability test. A deferred tax benefit would generally be recorded if it is more likely than not that it will be realized. See ARM 5790 for additional information on the interaction of FAS 109, "Accounting for Income Taxes," with OPEB.

Other book/tax differences may result from different computation methods. For example, amounts capitalized as part of the cost of inventory under FAS 106 will generally differ from the cost required to be capitalized for tax purposes. In addition, companies using the LIFO method for valuing inventory may use different OPEB cost methods for financial reporting and tax purposes; this is not a LIFO conformity issue but rather a LIFO computation difference.

.68 Rate-Regulated Enterprises

EITF 92-12, "Accounting for OPEB Costs by Rate-Regulated Enterprises" and EITF 93-4, "Accounting for Regulatory Assets," state that OPEB costs that fail to meet the regulatory asset recognition requirements should not be an asset. EITF 92-12 also states that if certain defined requirements of the EITF are met, a regulatory asset should be recognized. EITF 93-4 concludes that if the enterprise meets those requirements in a subsequent period, then a regulatory asset should be recognized in that period.

A utility company that has been amortizing its transition obligation may be deferring the recognition of the amounts amortized because it meets the conditions outlined in paragraphs c. and d. of the consensus in EITF 92-12. Under EITF 92-12, it may defer the recognition of a curtailment loss provided that it has a rate order that allows for the recovery of postretirement benefit cost determined in conformity with generally accepted accounting principles. However, because a curtailment changes the ultimate timing of cash outflows (i.e., for benefit payments), it is important that there be no significant unrecovered costs at the end of the period over which recovery of costs is allowed by the rate order. In addition, it is important that the curtailment not cause the regulator to reconsider the rate order.

.69 Interim Measurements

Under FAS 106, par. 73, a significant event, such as a plan amendment, settlement, or curtailment, would ordinarily call for an interim measurement to be performed. The assumptions used for the interim measurement should be reflected in the net periodic postretirement benefit cost from the date of the interim measurement to the year-end. Refer to ARM 4270.366 for a more detailed discussion of interim measurements.

In some cases, an employer's new beginning-of-the-year actuarial valuation might not be completed before employer must issue its interim financial information. ARM 4380.4 discusses an employer's interim period accounting for net periodic OPEB cost in these situations.

.7 SETTLEMENTS, CURTAILMENTS AND TERMINATION BENEFITS

The OPEB and pension accounting models both provide for delayed recognition of actuarial gains and losses, the cost of plan amendments, and transition amounts. However, both also define limits to this concept by specifying events or transactions that accelerate the recognition of previous deferrals. For OPEB, these events include settlement of all or a portion of the OPEB obligation, as well as curtailments of the plan (i.e., reductions in expected future years of employee service or in benefits earned for future service).

Previously unrecognized amounts would be recognized when all of the following events occur:

- All OPEB obligations are settled
- Defined benefits are no longer earned under the plan and the plan is not replaced by another defined benefit plan
- There are no remaining plan assets
- All employees are terminated
- The plan ceases to exist

If some, but not all, of the above events occur, or where the events occur with respect to only part of the plan, current recognition of certain elements of or some portion of the deferred amounts may be appropriate. FAS 106 requires pro rata recognition if part of the plan's obligation is settled or part of the plan is curtailed.

For purposes of settlement and curtailment accounting, any transition obligation arising from implementation of FAS 106 is treated as prior service cost, as it is assumed to relate principally to service rendered in prior periods. Any transition asset (a rare situation) is treated as an actuarial gain, as it is assumed to relate principally to investment gains.

.71 Settlement Accounting

A settlement is an irrevocable action relieving the employer (or the plan) of primary responsibility for a postretirement benefit obligation and transferring risk so that the employer (or plan) has eliminated significant risk related to the obligation and the assets used in effecting the settlement. For example, an OPEB obligation may be settled by making lump-sum payments to participants in exchange for their rights to receive specified benefits or by purchasing nonparticipating (and certain participating) insurance contracts for the accumulated postretirement benefit obligation for all or some of the plan's participants. However, because of the nature of OPEB obligations, settlements are very rare. Typically, settlements result from the sale of a portion of the business where the buyer assumes the OPEB obligation (see Illustration 10 of Appendix C in FAS 106, par. 502-506).

FAS 106 views settlement of all or a portion of an employer's APBO as final realization of past actuarial gains or losses associated with the settled obligation because of the elimination of employer risk. A subsequent decision to continue the plan or adopt another defined benefit plan does not affect the gain or loss recognized on settlement.

Unrecognized prior service cost does not enter into the gain or loss on settlement. The implicit assumption underlying the delayed recognition of prior service cost (i.e., that the employer receives future economic benefits from plan amendments) is unaffected by the decision to transfer payment responsibilities and risks for all or a portion of the OPEB obligation to a third party.

In accounting for a settlement, the APBO must first be remeasured using current assumptions, and plan assets (if any) must be remeasured at their then fair value. The remeasurement adjustment (i.e., the increase or decrease in the APBO and plan assets) is an actuarial gain or loss and is included in the unrecognized net gain or loss prior to settlement accounting.

In calculating the gain or loss upon settlement, a determination must also be made as to whether an additional portion of any remaining transition obligation is required to be recognized under the provisions of FAS 106, par. 112.

.72 Type of Insurance Contract Affects Settlement Accounting

The purchase of a nonparticipating insurance contract results in a settlement. The purchase of a participating contract may also result in a settlement if the substance of the contract allows the employer (or plan) to transfer a significant portion of the risks and rewards associated with the APBO and plan assets to the insurer. However, FAS 106 requires that the settlement gain that is otherwise recognizable must be reduced. Since the enterprise is still at risk for the participation right, an unrecognized net gain (but not an unrecognized net loss) must first be reduced by the cost of the participation right before calculating the amount to be recognized in income.

.721 Full settlement

A full settlement occurs only when the entire APBO is settled; for example, when the benefits earned to date by all plan participants are settled through the purchase of a nonparticipating insurance contract. In a full settlement, the employer recognizes the entire previously deferred net actuarial gain or loss (including any remaining transition asset). However, if that amount is a gain, the gain must first reduce any remaining transition obligation. Any excess gain would be recognized in income.

FASB Q&A.106, question 46 discusses a scenario where an employer that immediately recognized its transition obligation subsequently amends its plan to eliminate its obligation for postretirement benefits and settle its remaining obligation and partially compensates affected participants by increasing their pension benefits. The cost to the employer of settling its OPEB obligation is the increase in the obligation for pension benefits; therefore, the gain on the termination of the plan must be measured taking into account the cost of the pension benefit increase. In the event that the prior service cost of the enhanced pension benefit exceeds the OPEB obligation, the excess should be amortized similar to any other prior service cost.

.722 Partial settlement

When only part of the APBO is settled (for example, when the APBO for retirees, but not active plan participants, is settled), the employer recognizes a pro rata portion of the aggregate previously deferred net actuarial gain or loss (including any remaining transition asset). But, if that pro rata amount is a gain, an employer must first reduce any remaining transition obligation (not just a pro rata portion thereof). Any excess gain would be recognized in income. The pro rata factor is computed as the percentage reduction in the APBO due to the partial settlement. Illustration 8 of Appendix C in FAS 106, par. 484-495 provides examples of the calculations required to determine amounts recognized in a partial settlement.

A partial settlement does not occur if a portion of the obligation for vested benefits to all plan participants is satisfied and the employer remains liable for the balance of the participants' vested benefits. (See FASB Q&A.88, question 8.) If a plan has two discrete benefit obligations for all plan participants (e.g., each obligation under the single plan reflects a different benefit promise and is based on different benefit formulas) and only one of those obligations is settled, settlement accounting may apply with respect to that obligation depending on the facts and circumstances. Refer to EITF 03-2, "Accounting for the Transfer to the Japanese Government of the Substitutional Portion of Employee Pension Fund Liabilities."

.723 Curtailment accounting

Definition and Timing

Curtailment accounting applies when an event occurs that significantly reduces the expected years of future service of active plan participants (e.g., a reduction in the work force from a downsizing of operations or plant closing) or eliminates defined benefits for future services of a significant number of plan participants (e.g., a plan termination or suspension). FASB Q&A.106, question 24, 25 and 30 discuss the differences between a negative plan amendment and a curtailment. In particular, Example 3 in the answer to FASB Q&A.106, question 30 helps distinguish the limited situation in which curtailment accounting (as contrasted to negative plan amendment accounting) is appropriate where there has not been a termination of employee services earlier than expected.

A curtailment is an event separate from a settlement, but in certain situations both may occur. For example, if an employer settles all or a portion of a defined benefit OPEB obligation, but the plan or a successor defined benefit plan continues to provide benefits for future service, a curtailment has generally not occurred, as benefits related to future service are not eliminated. However, if the plan is terminated and replaced by a defined contribution plan, a curtailment as well as a settlement results, as benefits are no longer earned for future service under a defined benefit plan. This may occur during a sale of a portion of a business in which case Illustration 10 of Appendix C in FAS 106, par. 502-506 should be followed. (Note: In some cases, particularly when the buyer does not create a successor plan, a sale of a portion of a business will be accounted for as a curtailment under Illustration 9B of Appendix C in FAS 106, par. 500-501.)

The gain or loss to be recognized from a plan curtailment comprises two elements: (1) the unrecognized prior service cost or negative prior service cost associated with the decline in expected years of future service; and (2) the change in the accumulated benefit obligation, net of applicable actuarial gains or losses. The combined effect of these measurements – the net gain or net loss – dictates the timing of recognition. Both the APBO and plan assets are remeasured before effecting curtailment accounting.

A net curtailment loss is recorded when it is probable that a curtailment will occur and the amount of the curtailment loss is reasonably estimable. A net curtailment gain is deferred until realized (i.e., upon termination of benefits or employees).

Judgment will be required in determining what constitutes a significant portion of expected years of future service and a significant number of plan participants; FAS 106 and FASB Q&A.106 do not provide quantitative guidelines. Absent other considerations, we believe that a 10 percent or greater reduction would be significant, while a reduction of 5 percent or less would not. Reductions between 5 and 10 percent should be evaluated based on specific facts and circumstances. Whatever quantitative threshold is determined to be significant, we believe that such a practice should be followed on all subsequent curtailments with similar circumstances. Judgment will also be required when assessing the facts and circumstances of layoffs expected to be temporary. A curtailment occurs when it is no longer probable that specific employees will be rehired. For example, if workers are furloughed for a period of months and others are hired to replace them, a curtailment has occurred. However, if the employer has not replaced the workers, and based on present intentions it is reasonable to expect the furloughed employees to return to the employer's work force, a curtailment has not occurred.

Prior Service Cost Recognized in a Curtailment

Unrecognized prior service cost for purposes of curtailment accounting comprises the unamortized cost of amendments subsequent to transition and any remaining transition obligation. When the work force has been reduced or the accrual of benefits for some or all future services has been eliminated, the employer will not realize all of the expected future economic benefits of prior service cost over future periods. Consequently the prior service cost relating to the affected employees and the change in the accumulated postretirement benefit obligation is recognized immediately.

The unrecognized prior service cost to be recognized is computed as follows:

$$\frac{\text{Reduction in expected years of future service}}{\text{Expected years of future service prior to curtailment}} \times \begin{array}{c}\text{Unrecognized prior}\\ \text{service cost}\\ \text{(including transition}\\ \text{obligation)}\end{array}$$

The above calculation is performed separately for any transition obligation and each plan amendment, based on those employees active at the date of transition and at the date of each plan amendment. In calculating the percentage reduction in expected years of future service related to any transition obligation, the expected years of future service through the retirement date is used. For plan amendments, expected years of future service to the full eligibility date is used. These periods are consistent with the periods over which the transition obligation and prior service cost are generally amortized.

APBO Change Recognized in a Curtailment

A curtailment may cause the APBO to decrease (a gain) or increase (a loss). For example, an OPEB obligation based on employees' projected final compensation levels normally will be reduced if employees' services are terminated earlier than had been expected (a curtailment gain). On the other hand, if employees' services are terminated and the acceptance rate for early retirement benefits provided by the plan exceeds estimated rates of acceptance prior to the curtailment, and if such benefits are not actuarially reduced, the APBO will increase since there will be an increase in the present value of the benefit payments (a curtailment loss). (Note: The accounting would be different if a negative plan amendment caused the reduction in the APBO and also simultaneously caused a curtailment.)

A curtailment gain or loss resulting from a change in the APBO must be reduced by any unrecognized net actuarial loss or gain before being recognized. The theory behind this offsetting is that the portion of the APBO being eliminated or created by the curtailment may not have been fully recognized in net periodic OPEB cost. For example, part of the obligation may have arisen from changes in actuarial assumptions not yet fully amortized. Thus, the curtailment gain or loss is first reduced by any unrecognized actuarial loss or gain. Four potential scenarios and the related net gain or loss to be recognized follow:

- The APBO decreases, resulting in a curtailment gain. A net unrecognized actuarial loss exists at the date of curtailment. The excess, if any, of the curtailment gain over the unrecognized actuarial loss is recognized along with the acceleration of prior service cost.

- The APBO decreases, resulting in a curtailment gain. A net unrecognized actuarial gain (including any remaining transition asset) exists at the date of curtailment. No offsetting is required; the full curtailment gain is recognized along with the acceleration of prior service cost.

- The APBO increases, resulting in a curtailment loss. A net unrecognized actuarial gain exists at the date of curtailment. The excess, if any, of the curtailment loss over the unrecognized actuarial gain is recognized along with the acceleration of prior service cost.

- The APBO increases, resulting in a curtailment loss. A net unrecognized actuarial loss exists at the date of curtailment. No offsetting is required; the full curtailment loss is recognized along with the acceleration of prior service cost.

Note that the net unrecognized actuarial loss or gain applied to reduce the curtailment gain or loss relates to the plan as a whole, while the curtailment may represent the reduction in expected future years of service of only a portion of the entire plan service years or the participants. FAS 106 requires the use of the entire actuarial loss or gain because of the uncertainty regarding the origin of those amounts. That is, an portion of the net actuarial gain or loss relates to the portion of the APBO being curtailed, thereby not permitting specific or proportionate offsetting.

.73 Combined Settlement and Curtailment

When a related series of transactions involves both a partial settlement and a curtailment, and the accumulated postretirement benefit obligation changes as a result of the curtailment, gain or loss recognition may differ depending upon the order of applying settlement and curtailment accounting. This is because the pro rata factor for determining settlement gain or loss recognition is based upon the portion of the presettlement APBO settled. For example, assume the APBO before effecting settlement and curtailment accounting is $2,000,000. The curtailment causes a $200,000 reduction in the APBO, and benefits of $1,200,000 are settled. If curtailment accounting is effected first, 67% ($1,200,000/$1,800,000) of the net gain or loss would be recognized on settlement. If the settlement is recorded first, 60% ($1,200,000/$2,000,000) of the net gain or loss would be recognized. If the plan were in a $450,000 net gain position, the curtailment gain would be $200,000 (the reduction in the APBO) in either case; however, the settlement gain would be $300,000 (67% of $450,000) if the curtailment were recorded first, and $270,000 (60%) if the settlement were recorded first.

The order of recording curtailment and settlement events is not specified by FAS 106. However, FASB Q&A.88 states that the selection of the event to be recognized is an arbitrary decision and that neither order is superior to the other. We believe the curtailment decision would generally precede the settlement decision; consequently, we believe that curtailment accounting should preferably be effected before settlement when both arise as a result of a related series of transactions (ARM 4270.44). The FASB staff indicated that once an approach has been selected, it should be consistently followed.

.74 Termination Benefits

FAS 106 requires that postretirement benefits offered as "special" or "contractual" termination benefits be accounted for pursuant to FAS 88, "Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits" (see ARM 4270.45). The accounting recognition for the two types of termination benefit arrangements is triggered at different times. Accounting recognition of special termination benefits is based on employee acceptance; contractual termination benefits are recognized based on FAS 5 probability considerations. The FASB recognized this inconsistency but concluded that the differing nature of the two events warrants different treatment. In the case of special termination benefits, it is the employees, not the employer, who elect termination, and no obligation arises until the employees make that election. However, an employer is legally bound to pay contractual termination benefits whenever the specified event occurs, and the benefits should be accrued when the decision causing the event is made. Termination benefits often, but not always, arise in connection with a plan curtailment; for example, a substantial reduction in the work force due to a restructuring or plant closing. Illustration 11 of Appendix C in FAS 106, par. 507-511 provides an example of accounting for special termination benefits in connection with a plan curtailment.

The liability and cost for special termination benefits offered through an OPEB plan is calculated as the difference in the APBO with and without consideration of those benefits. For this purpose, the APBO is calculated for employees accepting the special benefits assuming: (1) those who are active employees not yet eligible for benefits would terminate at their full eligibility date; and (2) those who are fully eligible plan participants would retire immediately. FASB Q&A.106, question 48 provides an example of accounting for special termination benefits in connection with an early termination.

There may be situations where a special termination benefit offer extends beyond the end of a reporting period. Acceptances through the period end should be recorded as a termination liability; the contingent liability for offers still outstanding should be disclosed, if significant, pursuant to FAS 5.

There may also be situations where, in connection with a curtailment, employees elect either a cash severance package or a special termination benefit. For example, employees may be given a choice between special termination benefits with an estimated present value of $10,000 or a cash payment of $8,000. Since it is clear that the employer's minimum liability is $8,000 per terminating employee, the loss provision should be recorded on that basis as part of the curtailment. If employees elect the higher benefit, the additional $2,000 would be provided.

FAS 146, "Accounting for Costs Associated with Exit or Disposal Activities," is effective for exit or disposal activities initiated after December 31, 2002. Although it prescribes the accounting for one-time termination benefits, which it defines as benefits that are established by a plan of termination that applies for a specified termination event or for a specified future period, FAS 146 does not amend the accounting for termination benefits paid through a preexisting plan, including contractual termination OPEB benefits currently accounted for under FAS 106. Refer to ARM 1086 and ARM 4390 for more detailed discussion of FAS 146.

.75 Settlement, Curtailment and Termination Benefits as Part of a Disposal of a Component of an Entity

For a detailed discussion of the reporting considerations for settlement, curtailment and termination benefits related to a disposal of a component of an entity, refer to ARM 4270.46.

.8 FAS 106 AND BUSINESS COMBINATIONS

FAS 106 effectively requires that when accounting for a purchase business combination, the assignment of purchase price must include an obligation (or asset) related to any assumed single-employer defined benefit OPEB plan. An OPEB obligation is recorded for the excess of the assumed accumulated postretirement benefit obligation over the fair value of plan assets, or an asset is recorded for the excess of the fair value of plan assets over the assumed obligation, all measured at the date the purchase is consummated.

In recording the assumed net obligation (or asset) the accumulated postretirement benefit obligation and the plan assets should be measured at the acquisition date using current assumptions (determined by the acquiror) and the terms of the substantive plan to be provided by the acquiror. For example, the measurement would reflect the acquiror's intentions regarding the plan (including termination, suspension and reduction of benefits) and the acquired operations, including reductions in the work force and plant closings.

In situations where the acquiror grants credit for prior service to employees of the acquiree solely as a condition of the acquisition, the increase in the obligation related to such credit would be considered a cost of the acquisition. Otherwise, the increased benefits would be accounted for as a plan amendment, amortized a delayed basis in accordance with the requirements for prior service cost recognition. If acquired employees will receive reduced, instead of increased, benefits under the acquiring company's pension plan versus what they would have received under the acquired company's plan, the same guidance would apply. That is, whether the effects of the change in benefits should be reflected in the purchase price allocation depends on whether the change in benefits occurs as a condition of the acquisition, not whether the change results in an increase or decrease in benefits.

For a multiemployer plan, an estimated withdrawal liability is recorded only if it is probable that the enterprise will withdraw from the plan.

Refer to ARM 4270.38 for a discussion of (1) EITF 96-5, "Recognition of Liabilities for Contractual Termination Benefits or Changing Benefit Plan Assumptions in Anticipation of a Business Combination," (2) the accounting treatment in the event of reimbursement by the seller of payments by the buyer to retired participants, (3) the accounting treatment when a venturer purchases its co-venturer's interest and as a condition of the purchase assumes responsibility for the benefit obligation, and (4) the accounting treatment when enhanced benefits are offered as part of a voluntary termination program, which is not contingent upon the acquisition.

.9 MANAGEMENT'S DISCUSSION AND ANALYSIS

Some companies have made substantial changes to their postretirement benefit plans that could have a material impact on the results of operations and cash flows of those companies. The changing values in the stock markets, and changes in interest rates and healthcare cost trend rates can also have a material impact on a company's postretirement benefit plan, including the cost and funding requirements of the plan. The SEC staff believes that such events should be discussed in Management's Discussion and Analysis (MD&A) in accordance with Item 303 of Regulation S-K and Financial Reporting Codification Section 501 (SEC FRP 501 (see SEC 4930)).

SEC FRP 501 requires that a company address in MD&A known trends or uncertainties that will have a material impact on income, liquidity, or capital resources. The staff believes that if it is reasonably likely that certain events will occur and those events could have a material impact on a company's financial results, this fact should be disclosed in MD&A.

The following events also may warrant disclosure in the MD&A:

- A change in the composition of the benefits package,
- A change in the assumptions used that will likely result in a higher OPEB expense in the next fiscal year (e.g., a lower assumed rate of return on plan assets, a lower discount rate, or a higher health care cost trend rate),

- Expected higher funding requirements,

- The amount of unrecognized losses on plan assets and the estimated effect of those losses on future OPEB expense,

- How the registrant determines various assumptions (including the source of data used to determine those assumptions) and how those assumptions could influence the registrant's results of operations and financial position, and

- How the registrant's financial statements have been impacted by changes in assumptions and or by changes in the current economic environment.

Refer to ARM 4270.9 for a further discussion of the types of matters the SEC staff expects registrants to address in their MD&A involving the expected long-term rate of return on plan assets.

NSTAR One NSTAR Way, Westwood, MA 02090

March 1, 2004

PricewaterhouseCoopers LLP
One International Place
Boston, MA 02110

We are providing this letter in connection with your audits of the consolidated financial statements of NSTAR (the "Company") as of December 31, 2003 and 2002 and for each of the three years in the period ended December 31, 2003 for the purpose of expressing an opinion as to whether such consolidated financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of NSTAR in conformity with accounting principles generally accepted in the United States of America. We confirm that we are responsible for the fair presentation in the consolidated financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

Certain representations in this letter are described as being limited to those matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, as of January 20, 2004, the date of your report, the following representations made to you during your audit:

1. The consolidated financial statements referred to above are fairly presented in conformity with accounting principles generally accepted in the United States of America, and include all disclosures necessary for such fair presentation and disclosures otherwise required to be included therein by the laws and regulations to which the Company is subject.

2. We have made available to you all:

    a. Financial records and related data.

    b. Minutes of the meetings of stockholders, trustees, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared. The most recent meetings held were: January 22, 2004.

3. There have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.

4. There are no material transactions, agreements or accounts that have not been properly recorded in the accounting records underlying the consolidated financial statements.

5. The effects of the uncorrected financial statements differences summarized in the accompanying schedule are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

6. Receivables recorded in the consolidated financial statements represent bona fide claims against debtors for sales or other charges arising on or before the balance sheet dates and are not subject to discount except for normal cash discounts. Receivables classified as current do not include any material amounts which are collectible after one year. All receivables have been appropriately reduced to their estimated net realizable value.

7. Inventories recorded in the consolidated financial statements are stated at the lower of cost or market, cost being determined on the basis of average cost, and due provision was made to reduce all slow-moving, obsolete, or unusable inventories to their estimated useful or scrap values. Inventory quantities at the balance sheet dates were determined from physical counts or from the Company's perpetual inventory records, which have been adjusted on the basis of physical inventories taken by competent employees at various times during the year. Liabilities for amounts unpaid are recorded for all items included in inventories at balance sheet dates.

8. All liabilities of the Company of which we are aware are included in the consolidated financial statements at the balance sheet dates. There are no other liabilities or gain or loss contingencies that are required to be accrued or disclosed by Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*, and no unasserted claims or assessments that our legal counsel has advised us are probable of assertion and required to be disclosed in accordance with that Statement.

   Additionally, the provisions for management incentive compensation ("The 2003 NSTAR Incentive Plan for Non-Represented Employees") and self-insurance reserves represent management's best estimates of the amounts that will be paid under these plans.

9. There are no significant deficiencies, including material weaknesses, in the design or operation of internal control over financial reporting that are reasonably likely to adversely affect the Company's ability to record, process, summarize and report financial data. (We understand the term "material weaknesses" to mean those matters described in Statement of Auditing Standards No. 60.)

10. We acknowledge our responsibility for the design and implementation of programs and controls to provide reasonable assurance that fraud is prevented and detected.

11. We have no knowledge of any fraud or suspected fraud affecting the Company involving:

    a. Management,

    b. Employees who have significant roles in internal control over financial reporting, or

    c. Others where the fraud could have a material effect on the consolidated financial statements.

12. We have no knowledge of any allegations of fraud or suspected fraud affecting the Company received in communications from employees, former employees, analysts, regulators, short sellers, or others.

13. (As to items 10, 11 and 12, we understand the term "fraud" to mean those matters described in Statement on Auditing Standards No. 99.)

14. There have been no violations or possible violations of laws or regulations whose effects should be considered for disclosure in the consolidated financial statements or as a basis for recording a loss contingency.

15. The Company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities. The classification of debt at December 31, 2003 is consistent with management's intent and ability to refinance such debt.

16. The following, if material, have been properly recorded or disclosed in the consolidated financial statements:

    a. Related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties. (We understand the term "related party" to include those entities described in Statement on Auditing Standards No. 45, footnote 1.)

    b. Guarantees, whether written or oral, under which the Company is contingently liable.

    c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. (Significant estimates are estimates at the balance sheet date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.)

d. Subsequent events, other than those recorded in the accompanying schedule of unadjusted financial statement differences.

17. The Company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral, except as disclosed in the consolidated financial statements. Additionally,

    a. The Company's setoff on the consolidated financial statements of cash payments and debt related to BEC Funding LLC is appropriate within the terms of the note indenture and in accordance with FIN 39, *Offsetting of Amounts Related to Certain Contracts an interpretation of APB Opinion No. 10 and FASB Statement No. 105* (FIN 39).

    b. The Company has appropriately classified its cash balances unrelated to BEC Funding LLC in accordance with FIN 39.

18. The Company has complied with all aspects of contractual agreements that would have a material effect on the consolidated financial statements in the event of noncompliance.

19. The Company has appropriately reconciled its books and records (e.g., general ledger accounts) underlying the consolidated financial statements to their related supporting information (e.g., sub ledger or third-party data). All related reconciling items considered to be material were identified and included on the reconciliations and were appropriately adjusted in the consolidated financial statements. There were no material unreconciled differences or material general ledger suspense account items that should have been adjusted or reclassified to another account balance. There were no material general ledger suspense account items written off to a balance sheet account, which should have been written off to an income statement account and vice versa. All consolidating entries have been properly recorded. All intracompany and intercompany accounts have been eliminated or appropriately measured and considered for disclosure in the consolidated financial statements.

20. The unaudited interim financial information has been prepared and presented in conformity with accounting principles generally accepted in the United States of America applicable to interim financial information and with Item 302(a) of Regulation S-K. The unaudited quarterly financial information for the year ended December 31, 2003 also has been prepared on a basis consistent with the corresponding interim periods in the year ended December 31, 2002 and, to the degree appropriate, with the consolidated financial statements for the years ended December 31, 2003 and 2002. The unaudited interim financial information for the three months ended December 31, 2003 and 2002 does not include any material amount of year-end adjustments that have not been disclosed or any material amounts that should have been included in earlier interim periods of the respective fiscal years.

21. The Company does not have outstanding a past-due share of its accounting support fees collectible by the Public Company Accounting Oversight Board.

22. The liability for federal income taxes reflected in the balance sheet is adequate to cover any additional assessments resulting from examinations already made, or from those expected to be made by the Internal Revenue Service.

23. Through December 31, 2003 amounts have been accrued related to legal and hazardous waste exposures. We do not believe that any potential additional costs in excess of the accrued amounts associated with these exposures will have a material adverse effect (reduction of more than 10%) on common equity.

24. The financial statements disclose all information about the Company's operating segments, their products and services, the geographic areas in which they operate and their major customers as required by FASB No. 131, *Disclosures about Segments of an Enterprise and Related Information*.

25. The equity method is used to account for the Company's investment in the common stock of Hydro-Quebec, Connecticut Yankee, Yankee Atomic, Vermont Yankee, and Maine Yankee because the Company has the ability to exercise significant influence over operating and financial policies of the entities. All balances related to these investments are probable of future recovery.

26. All deferred costs (regulatory assets) recorded as of December 31, 2003 are probable of future recovery and are in accordance with the recognition criteria of FASB No. 71, *Accounting for the Effects of Certain Types of Regulation.*

27. The actuarial assumptions and methods used to measure liabilities and costs for financial accounting purposes for pension and other postretirement benefits are appropriate in the circumstances.

    a. The narrative descriptions of (a) investment policies and strategies, including the target allocation percentages or range of percentages for each major category of plan assets, and (b) the basis used to determine the overall expected long-term rate of return on assets assumption, represent an accurate description of the processes used by management to make investment decisions and to determine the overall expected long term rate of return on assets.

    b. The amount used for disclosure purposes of employer contributions expected to be paid to the benefit plans during the next fiscal year of approximately $63 million represents management's best estimate at December 31, 2003.

28. The Company is not aware of any material accounts receivable cancellations subsequent to January 1, 2003, through the date of this letter that should be reflected in 2003.

29. The Company believes that all amounts currently recorded as goodwill on the balance sheets are recoverable from customers. We also have reviewed goodwill and indefinite-lived intangibles for impairment in accordance with FASB Statement No. 142, *Goodwill and Other Intangible Assets*, and have appropriately recorded adjustments to the carrying value of these assets based on the results of the impairment tests. As of December 31, 2003, no adjustment was required.

30. In accordance with FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, we have assessed the carrying value, as of December 31, 2003, of fiber optic networks for impairment including its best estimate of probability factors and future cash flows. Management believes that no impairment occurred with its wholesale fiber optics network business as of December 31, 2003.

31. We have adopted FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities as amended by FASB Statement No. 138 and No. 149 and interpreted by Derivatives Implementation Group issues (together, "FAS 133") as of January 1, 2001.

    a. We have adequately disclosed each significant concentration of credit risk arising from all financial instruments whether from an individual counterparty or groups of counterparties in accordance with FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, as amended by FAS 133.

    b. We have evaluated the contracts into which we have entered to determine whether any such contracts are in effect hybrid instruments that contain embedded derivative instruments. For those embedded derivative instruments that (1) possess economic characteristics that are not clearly and closely related to the host contract and (2) meet the definition of a derivative instrument when considered on a stand-alone basis, we have bifurcated the embedded derivative instrument and accounted for it separately at fair value pursuant to the provisions of FAS 133.

    c. As of December 31, 2003, management provided its best estimate of values of the Mass Power, Dartmouth, and Altresco contracts based on expected future cash flows, assumptions regarding GNP, forward prices for electricity and appropriateness of discount rate. Management represents that this above market power contract liability will be fully recovered from customers through the Company's variable transition rate.

    d. We have evaluated all contracts and financial instruments to determine whether these meet the definition of a derivative under FAS 133 paragraphs 6-11 and the related Derivatives Implementation Group issues. We have designated certain contracts that meet the definition of a derivative as normal purchases and normal sales under paragraph 10(b) and as a result these are not required to be accounted for as derivatives under FAS 133. We believe that (1) it is probable that these contracts will result in physical delivery, (2) the quantities in these contracts are expected to be used or sold over a reasonable period in the normal course of business, and (3) these contracts have prices that are based on underlyings that are clearly and closely related to the assets being sold or purchased and are denominated in currencies that meet the criteria in paragraph 15(a) through 15(d).

32. The Company has reviewed tangible long-lived assets, operating lease agreements that contain return provisions that require the leased assets to be returned in the same condition that existed at lease inception (i.e., the agreement requires the removal of any leasehold improvements at the end of the lease term) and other agreements for associated asset retirement obligations (AROs), and have recognized related liabilities where required, in accordance with FASB Statement No. 143, *Accounting for Asset Retirement Obligations* (FAS 143).

    The methods and assumptions used to measure the fair value of recorded AROs are appropriate and reasonable under the circumstances and utilize the best available information. Additionally, the methods and assumptions used to measure the amount of removal costs that are not AROs within the scope of FAS 143 are appropriate and reasonable under the circumstances and utilize the best available information.

33. The Company has adopted and applied the relevant provisions of FASB Interpretation No. 46 (FIN 46), *Consolidation of Variable Interest Entities* or FASB Interpretation No. 46R (revised December 2003) (FIN 46R), *Consolidation of Variable Interest Entities,* and related FASB Staff Positions (FSPs) for all variable interest entities (VIEs) created after January 31, 2003, and special-purpose entities (SPEs) created prior to February 1, 2003. In this process the Company has properly:

    a. Identified variable interest(s) currently held in entities and determined whether the entity is a variable interest entity including reconsideration as described in paragraph 7. In making this determination for BEC Funding LLC, it was determined that the future collection of transition securitization revenues is sufficiently assured to assert that there are no expected losses that would be borne by the certificate holders.

    b. Complied with the disclosures requirements in paragraph 24 of FIN 46 or FIN 46R regarding VIEs that are not consolidated by the Company, but which the Company holds a significant variable interest.

34. The Company does not have the right of offset between the bank accounts held by NSTAR Electric and Gas, and therefore, the Company has reclassified only general ledger cash balances to short term liabilities where the book balances are less than zero individually, and not for all balances with the same banking institution.

35. In accordance with the Company's policy for uncertain tax positions, the Company has recorded a long term liability for the potential disallowance of tax deductions associated with the abandonment of its RCN investment. The Company believes that the realization of these deductions for tax purposes is less than probable.

36. We have provided you with information related to all significant income tax uncertainties with which we are aware. We have also provided you with access to all opinions and analyses provide by outside advisors that relate to positions we have taken in regard to significant income tax matters.

37. The Company does not currently have the ability to refinance its 7.80% debentures due March 15, 2023 that will be called for redemption subsequent to December 31, 2003. Because the Company currently does not meet the requirements of SFAS 6, *Classification of Short-Term Obligations Expected to Be Refinanced, an amendment of ARB No. 43,* this debt has been appropriately classified as short term in the consolidated financial statements.

To the best of our knowledge and belief, no events have occurred subsequent to the balance sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned consolidated financial statements.

Robert J. Weafer, Jr.
Vice President, Controller, Chief Accounting Officer

James J. Judge
Senior Vice President, Treasurer and Chief Financial Officer

Thomas J. May
Chairman, President and Chief Executive Officer

NSTAR One NSTAR Way, Westwood, MA 02090

November 7, 2003

PricewaterhouseCoopers LLP
One International Place
Boston, MA 02110

We are providing this letter in connection with your review of the condensed consolidated balance sheet of NSTAR and its subsidiaries (the "Company") as of September 30, 2003, and the related condensed consolidated statements of income, comprehensive income, and retained earnings for each of the three-month and nine-month periods ended September 30, 2003 and September 30, 2002 and the condensed consolidated statements of cash flows for the nine-month periods ended September 30, 2003 and September 30, 2002 for the purpose of determining whether any material modifications should be made to the condensed consolidated interim financial statements for them to conform with accounting principles generally accepted in the United States of America. We confirm that we are responsible for the fair presentation of the condensed consolidated interim financial statements contained in the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003 in conformity with generally accepted accounting principles.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, as of November 7, 2003, the following representations made to you during your review:

1. The condensed consolidated interim financial statements referred to above have been prepared and presented in conformity with generally accepted accounting principles applicable to interim financial information and on a basis consistent with the corresponding interim periods ended September 30, 2002 and, to the degree appropriate, with the audited financial statements for the year ended December 31, 2002.

2. We have made available to you:

   a. All financial records and related data.
   b. All minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes

have not yet been prepared. All significant board and committee actions are included in the summaries.

3. There are no significant deficiencies, including material weaknesses, in the design or operation of internal control over financial reporting that are reasonably likely to adversely affect the company's ability to record, process, summarize, and report interim financial data.

4. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.

5. We have no knowledge of any fraud or suspected fraud affecting the company involving:

   a. Management;

   b. Employees who have significant roles in internal control over financial reporting; or

   c. Others where the fraud could have a material effect on the interim financial information.

6. We have no knowledge of any allegations of fraud or suspected fraud affecting the company in communications from employees, former employees, analysts, regulators, short sellers, or others.

7. We have reviewed our representation letter to you, dated March 17, 2003, with respect to the audited financial statements for the year ended December 31, 2002. We now confirm those representations 1 through 37, which, to the degree appropriate, apply to the interim financial statements referred to above, and incorporate them herein, with the following changes:

   Representation 33 is modified by appending the following: Management has determined that the ARO for NSTAR Gas is immaterial to the financial statements of NSTAR and NSTAR Gas taken as a whole. We confirm that:

   a. It is probable that, subject to the estimates inherent in establishing this liability, the amounts accrued for profit margin and market-risk premium imbedded in this ARO will be spent; and

   b. NSTAR Gas is currently collecting equivalent costs from ratepayers, and it is probable that the amounts accrued for profit margin and market-risk premium imbedded in this ARO will be fully recovered from ratepayers.

To the best of our knowledge and belief, no events have occurred subsequent to the interim balance sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned condensed consolidated interim financial statements.

Robert J. Weafer, Jr.
Vice President, Controller, Chief Accounting Officer

James J. Judge
Senior Vice President, Treasurer and Chief Financial Officer

Thomas J. May
Chairman of Board and Chief Executive Officer

NSTAR ELECTRIC GAS
One NSTAR Way
Westwood, Massachusetts 02090

March 17, 2003

PricewaterhouseCoopers LLP
One International Place
Boston, MA 02110

We are providing this letter in connection with your audits of the consolidated financial statements of NSTAR (the "Company") as of December 31, 2002 and 2001 and for the years then ended for the purpose of expressing an opinion as to whether such consolidated financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of NSTAR in conformity with accounting principles generally accepted in the United States of America. We confirm that we are responsible for the fair presentation in the consolidated financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

Certain representations in this letter are described as being limited to those matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, as of January 22, 2003 the date of your report, the following representations made to you during your audit:

1. The consolidated financial statements referred to above are fairly presented in conformity with accounting principles generally accepted in the United States of America, and include all disclosures necessary for such fair presentation and disclosures otherwise required to be included therein by the laws and regulations to which the Company is subject.

2. We have made available to you all:

    a. Financial records and related data.

    b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared. The most recent meetings held were: January 23, 2003.

3. There have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.

4. There are no material transactions, agreements or accounts that have not been properly recorded in the accounting records underlying the consolidated financial statements.

5. The effects of the uncorrected financial statements misstatements summarized in the accompanying schedule are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

6. Receivables recorded in the consolidated financial statements represent bona fide claims against debtors for sales or other charges arising on or before the balance sheet dates and are not subject to discount except for normal cash discounts. Receivables classified as current do not include any material amounts, which are collectible after one year. All receivables have been appropriately reduced to their estimated net realizable value.

7. Inventories recorded in the consolidated financial statements are stated at the lower of cost or market, and due provision was made to reduce all slow-moving, obsolete, or unusable inventories to their estimated useful or scrap values. Inventory quantities at the balance sheet dates were determined from physical counts or from the Company's perpetual inventory records, which have been adjusted on the basis of physical inventories taken by competent employees at various times during the year.

8. All liabilities of the Company of which we are aware are included in the consolidated financial statements at the balance sheet dates. There are no other liabilities or gain or loss contingencies that are required to be accrued or disclosed by Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*, and no unasserted claims or assessments that our legal counsel has advised us are probable of assertion and required to be disclosed in accordance with that Statement.

9. There are no significant deficiencies, including material weaknesses, in the design or operation of internal controls, which could adversely affect the Company's ability to record, process, summarize and report financial data.

10. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.

11. We have no knowledge of any fraud or suspected fraud affecting the entity involving:

    a. Management,

    b. Employees who have significant roles in internal control, or

    c. Others where the fraud could have a material effect on the consolidated financial statements.

12. We have no knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, short sellers, or others.

13. (As to items 10, 11. and 12. we understand the term "fraud" to mean those matters described in Statement on Auditing Standards No. 99.)

14. There have been no violations or possible violations of laws or regulations whose effects should be considered for disclosure in the consolidated financial statements or as a basis for recording a loss contingency.

15. The Company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.

16. The following, if material, have been properly recorded or disclosed in the consolidated financial statements:

    a. Related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties. (We understand the term "related party" to include those entities described in Statement on Auditing Standards No. 45, footnote 1.)

    b. Guarantees, whether written or oral, under which the Company is contingently liable.

    c. Significant estimates and material concentrations known to management that is required to be disclosed in accordance with the AICPA's Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. (Significant estimates are estimates at the balance sheet date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.)

17. The Company has satisfactory title to all owned assets, and there are no liens or encumbrances on material assets nor has any asset been pledged as collateral, except as disclosed in the consolidated financial statements.

18. The Company has complied with all aspects of contractual agreements that would have a material effect on the consolidated financial statements in the event of noncompliance.

19. The unaudited interim financial information has been prepared and presented in conformity with accounting principles generally accepted in the United States of America applicable to

interim financial information and with Item 302(a) of Regulation S-K. The unaudited quarterly financial information for the year ended December 31, 2002 also has been prepared on a basis consistent with the corresponding interim periods in the year ended December 31, 2001 and, to the degree appropriate, with the consolidated financial statements for the years ended December 31, 2002 and 2001. The unaudited interim financial information for the three months ended December 31, 2002 and 2001 does not include any material amount of year-end adjustments that have not been disclosed or any material amounts that should have been included in earlier interim periods of the respective fiscal years.

20. The Company believes that it is probable, regardless of the outcome of its discussions with the Internal Revenue Service, it will be allowed to recover from ratepayers any taxes and interest paid in connection with the sale of COM/Energy generating assets.

21. The liability for federal income taxes reflected in the balance sheet is adequate to cover any additional assessments resulting from examinations already made, or from those expected to be made by the Internal Revenue Service.

22. Through December 31, 2002 adequate amounts have been accrued related to legal and hazardous waste exposures. We do not believe that any potential additional costs in excess of the accrued amounts associated with these exposures will have a material adverse effect (reduction of more than 10%) on common equity.

23. The deferred tax asset valuation allowance has been determined pursuant to the provisions of FASB Statement No. 109, *Accounting for Income Taxes,* including the Company's estimation of future taxable income, if necessary, and is adequate to reduce the total deferred tax asset to an amount that will, more likely than not, be realized.

24. The financial statements disclose all material information about the Company's operating segments, their products and services, the geographic areas in which they operate and their major customers as required by FASB No. 131, *Disclosures about Segments of an Enterprise and Related Information*.

25. The equity method is used to account for our investments in the common stock of Hydro-Quebec, Connecticut Yankee, Yankee Atomic, Vermont Yankee, and Maine Yankee because we have the ability to exercise significant influence over operating and financial policies.

26. All material deferred costs recorded as of December 31, 2002 are probable of future recovery.

27. The actuarial assumptions and methods used to measure liabilities and costs for financial accounting purposes for pension and other postretirement benefits are appropriate in the circumstances.

28. The Company is not aware of any material accounts receivable cancellations subsequent to January 1, 2003, through the date of this letter that should be reflected in 2002.

29. The Company believes that all amounts currently recorded as goodwill on the balance sheets are recoverable from customers.

30. The Company has adopted and applied the relevant provisions of FASB Statement No. 141, *Business Combinations*, and FASB Statement No. 142, *Goodwill and Other Intangibles*, as of January 1, 2002. In this process the Company has properly:

    a. Determined that no reclassification of intangibles out of the amount(s) previously reported as goodwill (in accordance with the transition provisions outlined in paragraph 61(b) of FASB Statement No.141, paragraph 49(b) of SFAS 142, and EITF Topic D-100, *Clarification of Paragraph 61(b) of FASB Statement No. 141 and Paragraph 49(b) of FASB Statement No. 142*) was necessary.

    b. Identified and established all reporting units, as defined in paragraphs 30 and 31 of FASB Statement No. 142 and assigned the Company's assets and liabilities, including goodwill and intangible assets to these reporting units in accordance with paragraphs 31-35 and 54 of FASB Statement No. 142.

31. We also have reviewed goodwill and indefinite-lived intangibles for impairment in accordance with FASB Statement No. 142, *Goodwill and Other Intangible Assets*, and have appropriately recorded adjustments to the carrying value of these assets based on the results of the impairment tests.

32. In accordance with FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, we have assessed the carrying value, as of December 31, 2002, of fibre optics networks for impairment including its best estimate of probability factors and future cash flows. Management believes that no impairment has occurred with any fiber optics network as of December 31, 2002.

33. We have adopted FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities as amended by FASB Statement No. 138 and interpreted by Derivatives Implementation Group issues (together, "FAS 133") as of January 1, 2001.

    a. We have adequately disclosed each significant concentration of credit risk arising from all financial instruments whether from an individual counterparty or groups of counterparties in accordance with FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, as amended by FAS 133.

b. We have evaluated the contracts into which we have entered to determine whether any such contracts are in effect hybrid instruments that contain embedded derivative instruments. For those embedded derivative instruments that (1) possess economic characteristics that are not clearly and closely related to the host contract and (2) meet the definition of a derivative instrument when considered on a stand-alone basis, we have bifurcated the embedded derivative instrument and accounted for it separately at fair value pursuant to the provisions of FAS 133. .

c. As of December 31, 2002, management provided its best estimate of values of the Mass Power, Dartmouth, and Alresco contracts based on expected future cash flows, assumptions regarding GNP, forward prices for electricity and appropriateness of discount rate. Management represents that it is probable that this above market power contract liability will be fully recovered from customers through the Company's variable transition rate.

d. We have evaluated all contracts and financial instruments to determine whether these meet the definition of a derivative under FAS 133 paragraphs 6-11 and the related Derivatives Implementation Group issues. We have designated certain contracts that meet the definition of a derivative as normal purchases and normal sales under paragraph 10(b) and as a result these are not required to be accounted for as derivatives under FAS 133. We believe that (1) it is probable that these contracts will result in physical delivery, (2) the quantities in these contracts are expected to be used or sold over a reasonable period in the normal course of business, and (3) these contracts have prices that are based on underlying assumptions that are clearly and closely related to the assets being sold or purchased and are denominated in currencies that meet the criteria in paragraph 15(a) or 15(b).

34. The Company has reviewed tangible long-lived assets, operating lease agreements and other agreements for associated asset retirement obligations (AROs) in accordance with FASB Statement No. 143, *Accounting for Asset Retirement Obligations*. The methods and assumptions used to measure the fair value of AROs as of January 1, 2003 are appropriate and reasonable under the circumstances and utilize the best available information. The Company believes that it has accurately estimated the appropriate adjustment to its credit-adjusted risk-free rate to reflect the uncertainty in the timing and amount of the related cash flows necessary to settle the Company's AROs.

35. The Company has no derivative contracts held for trading purposes or other contracts that would be accounted for in accordance with EITF Issue No. 02-3, *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities.*

36. The Company has adopted and applied the relevant provisions of FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including*

Indirect Guarantees of Indebtedness of Others, as of December 15, 2002. Disclosure includes the following:

a. The nature of the guarantee, including the approximate term of the guarantee.

b. The maximum potential amount of future payments.

c. The current carrying amount of the liability for the guarantor's obligations under the guarantee, regardless of whether the guarantee is freestanding or embedded in another contract.

d. The nature of (1) any recourse provisions that would enable the guarantor to recover from third parties any of the amounts paid under the guarantee and (2) any assets held either as collateral or by third parties that, upon the occurrence of any triggering event or condition under the guarantee, the guarantor can obtain and liquidate to recover all or a portion of the amounts paid under the guarantee. The guarantor shall indicate, if estimable, the approximate extent to which the proceeds from liquidation of those assets would be expected to cover the maximum potential amount of future payments under the guarantee.

37. On November 27, 2002, the Company filed a request for an accounting order with the MDTE to authorize an accounting practice whereby the Company would be allowed, unless otherwise ordered by the MDTE, to defer, and record as a regulatory asset, the amount of its current and future additional minimum pension liability to reflect the Company's ability to recover these costs in rates over time. The request further specified that a specific recovery mechanism to recover the deferred pension costs would be proposed in an upcoming rate case proceeding. On December 20, 2002, the MDTE approved the request.

In connection with the MDTE's approval of the accounting order, the Company has conducted an analysis of its legal right to recovery and of the prospects of a favorable recovery rate ruling in the future. In addition, as part of that analysis, the Company has also considered the potential impact of those parties who may seek to intervene to block recovery in the future rate case.

Based on our analysis, we represent that future recovery of the regulatory asset created at December 31, 2002 of $425.8 million attributable to the pension costs deferred as a result of the MDTE's approval of the aforementioned accounting order is probable. We further represent that our plan is to file a case with the MDTE in 2003, which will include a specific mechanism designed to recover the pension costs that have been deferred ($425.8 million) as of December 31, 2002.

To the best of our knowledge and belief, no events have occurred subsequent to the balance sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned consolidated financial statements.

Robert J. Weafer, Jr
Vice President, Controller, Chief Accounting Officer

James J. Judge
Senior Vice President, Treasurer and Chief Financial Officer

Thomas J. May
Chairman and Chief Executive Officer